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April 25, 2022

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F. Street NE
Washington, DC 20549-1090

Re: File No. S7-03-22

Dear Ms. Countryman:

The Committee on Private Investment Funds and the Committee on Investment Management Regulation of the New York City Bar Association ("**Committees**") submit this letter in response to the request of the Securities and Exchange Commission ("**Commission**") for comment in connection with Investment Advisers Act Release No. 5955 (February 9, 2022) which proposes new rules and amendments under the Investment Advisers Act of 1940 (the "**Advisers Act**") that would expand the regulatory framework to which private fund managers are subject

About the Association
The mission of the New York City Bar Association, which was founded in 1870 and has approximately 24,000 members, is to equip and mobilize a diverse legal profession to practice with excellence, promote reform of the law, and uphold the rule of law and access to justice in support of a fair society and the public interest in our community, our nation, and throughout the world.

(the "**Private Fund Proposal**", the "**Proposal**", the "**Release**" or the "**Proposed Rule**").[1] The Committees are composed of lawyers with diverse perspectives on investment management issues, including attorneys from law firms, counsel and compliance professionals to financial services firms, investment company complexes and investment advisers.

The Committees appreciate the opportunity to comment on the Private Fund Proposal and applaud the effort of the Commission and its staff (the "**Staff**") in putting forward these thoughtful proposals for public input. The Private Fund Proposal clearly reflects the hard work and dedication of the Commission and the Staff in discharging their mission to protect investors and facilitate capital formation.

In the sections that follow, we discuss various portions of the Proposal in turn, beginning with the Committees' thoughts with regard to Commission's Discussion of Proposed Rules for Private Fund Advisers (in Section I) and the Committee's thoughts with regard to the Commission's Discussion of Proposed Written Documentation of All Advisers' Annual Reviews of Compliance Programs (in Section II). As you will see, much of this letter is dedicated toward the former topic (Section I), with detailed discussions on Quarterly Statements, Mandatory Private Fund Adviser Audits, Adviser-Led Secondaries, Prohibited Activities and Preferential Treatment. The Committees then raise and discuss additional, broader observations—specifically, the statutory authority under which the Commission seeks to promulgate the final rule (in Section III) and a discussion regarding "grandfathering" (in Section IV).

Throughout the various sections of the letter, the Committees touch upon two common themes that warrant emphasis from the outset and that present themselves with frequency in this letter. The first is that most of the Proposed Rules appear to apply a singular solution to address multiple concerns, as referenced by terms such as "one size fits all" and similar phrases. As many of the issues that the Proposed Rules purports to address are multi-faceted and nuanced, the Committees believe it important to note that applying a singular approach is inherently difficult, likely to have unintended consequences and may in fact exacerbate problems, or create new ones in their place. An important objective of the Committees in drafting this letter was to ensure that the Commission was made aware of actual, specific examples of how this is likely to play out, rather than merely relying on a rhetorical device without specific support. We hope that this letter accomplishes that objective.

The second theme of this letter is that the Committees believe that many of the prescriptions of the Proposed Rules will meaningfully and practically impact the compliance burdens on advisers, not only in connection with actually complying with the Proposed Rules, but also in the hours that will be spent in analyzing them, determining how to comply with them and determining the circumstances in which they do not apply. These burdens will unquestionably translate into time that investors will spend with outside advisers, not the least of which are lawyers, accountants and fund administrators. The Committees caution that the expenses of these outside advisers *will*—not *may*—be charged to the investors that the Proposed Rules are intended to protect (particularly in the case of relatively smaller advisers who have less developed "back office" and related infrastructure). This, coupled with the observation that these investors are typically

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release No. IA-5955 (Feb. 9, 2022) (hereinafter "**Private Fund Advisers Release**").

sophisticated parties of considerable financial means who not only do not require the extra protections that the Proposal seeks to impose, but who we suspect would themselves prefer the flexibility to negotiate around (and, in most cases, have already negotiated) some of the restrictions that the Proposal would impose, lead the Committees to strongly caution that the Commission consider the tradeoff in costs and benefits to investors that these Proposed Rules would impart.[2]

The Committees suspect that many other comment letters that the Commission will receive regarding the Private Fund Proposal will also emphasize these two themes. We urge the Commission to give them strong consideration.

I. Discussion of Proposed Rules for Private Fund Advisers

A. Quarterly Statements

The Proposed Rule would require an investment adviser to prepare a quarterly statement that includes certain information regarding fees, expenses and performance for any private fund that it advises and distribute the quarterly statement to the private fund's investors within 45 days after each calendar quarter end. While the Committees agree that it is important for investors to assess and compare their private fund investments effectively, the Committees believe that advisers are already providing investors with sufficient disclosures on these items through financial statements and other reporting, and consequently that the costs that would be incurred to comply with these additional reporting obligations that will be borne by the private funds that the investment adviser manages (and passed on to investors) will likely outweigh the potential benefits to investors.

1. Fee and Expense Disclosure

a) Private Fund-Level Disclosure

Under the Proposed Rule, investment advisers would need to disclose, in a table format, (i) a detailed accounting of all compensation, fees and other amounts allocated or paid to the adviser or any of its related persons by the private fund during the reporting period (*e.g.*, management, advisory, sub-advisory or similar fees or payments, and performance-based compensation), (ii) a detailed accounting of all fund fees and expenses paid by the private fund during the reporting period (*e.g.*, organizational, accounting, legal, administration, audit, tax, due diligence and travel expenses), and (iii) the amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons.

[2] The Committees note that fund limited partners are typically represented by competent counsel and have access to fund terms across the spectrum. Accordingly, these investors make intentional choices to invest with particular managers with full opportunity to assess the relative risks and rewards of their choices. The Committees also note more broadly that conventions have developed over decades for many fund terms, such as in relation to tax and liability standards; meanwhile economic terms have been more fluid as the pendulum swings between limited partners and general partners. In cases where industry convention has settled out to balance risk, the Committees respectfully submit that the market conventions, rather than the Commission's mandates, are a more appropriate measure of how the risks of liability should be allocated between limited partners and general partners.

The Committees believe that requiring advisers to disclose adviser compensation and all fund fees and expenses both before and after the application of any offsets, rebates or waivers, with separate line items for each category of fee or expense would be unduly burdensome, time consuming and costly (with such costs likely to be passed to underlying investors). While the Committees recognize the importance of providing investors with transparency into the allocation of fees and expenses to private funds, the Committees believe that the scope of the Proposal is overbroad and that it is duplicative of certain reporting already being provided to and paid for by investors (*e.g.*, quarterly and annual financial statements), and thus that the incremental benefit that investors may receive from such new requirements would be outweighed by the added costs of producing the quarterly reports. To decrease compliance burdens, the Committees respectfully suggest that advisers be permitted to group expenses into broader categories and exclude expenses that are *de minimis*.

The Private Fund Proposal states a belief that investors are generally required to bear all expenses related to the operation of a fund and that these expenses are generally uncapped.[3] However, in practice, there are existing economic arrangements common in the market that incentivize advisers to monitor and minimize the expenses charged to the private funds that they manage. These arrangements align the interests between the adviser and investors and in practice operate to keep fund expenses at reasonable amounts. For example, an adviser (or affiliate) who has a significant investment in the private funds it manages has an aligned interest with the investors since the adviser would be bearing its pro rata share of fund expenses. In addition, fund expenses reduce the performance-based compensation that advisers receive (*i.e.*, fund expenses reduce the amount of profits generated by the fund, and accordingly the adviser's share of profits is lower than it would be absent the expense), further aligning the adviser's and the investors' interest in minimizing expenses.

Moreover, the Committees note that the economic terms of most private funds are heavily negotiated by sophisticated investors and are therefore driven and regulated by the market. The Committees' view is that it is not appropriate for the Commission to set parameters around how the adviser's fees should be calculated and how much and the types of fees advisers are allowed to charge. These terms should be established as a result of free-market negotiations and not mandated by a government agency.

Finally, the Committees caution that the Proposed Rule would have a disproportionately negative impact on smaller firms which generally do not have the back-office capability to comply with the requirements. Thus, an unintended consequence of finalizing the Proposed Rule, would be to make it more difficult for new advisers to enter the industry and harder for existing smaller advisers to grow. This would stifle competition.

b) Portfolio Investment-Level Disclosure

Under the Proposed Rules, advisers would need to disclose, in a table format, (i) a detailed accounting of all portfolio investment compensation allocated or paid by each "covered portfolio investment" during the reporting period, including origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees

[3] Private Fund Advisers Release, at 25.

or similar fees or payments by the covered portfolio investment to the investment adviser or any of its related persons and (ii) the private fund's ownership percentage of each such "covered portfolio investment" as of the end of the reporting period.

Since most private funds offset portfolio investment compensation against the management fee payable to the adviser, the Committees believe that it would be less costly but still serve similar ends if advisers were only required to disclose the amount of portfolio investment compensation received after the application of management fee offsets (rather than before and after, *i.e.*, all portfolio investment compensation) since most conflicts are eliminated where an allocable portion of such portfolio investment compensation is fully offset since the adviser is not receiving additional compensation. Accordingly, the Committees respectfully suggest that advisers should only be required to disclose the allocable portion of such fees that were not and will not be offset.

Also, if the adviser does not have control over whether to cause the covered portfolio investment to compensate the adviser or its related persons (*e.g.*, for funds that take minority positions, credit funds and others), the conflict of interest that the adviser has when it does control these decisions is not present. The Committees therefore believe that it would be more appropriate if advisers are only required to disclose portfolio investment compensation information if the adviser possesses such control.

Furthermore, the Committees believe that advisers should be required to disclose only the total portfolio investment compensation received rather than itemizing for each covered portfolio investment. Disclosing an aggregate number that covers all covered portfolio investments would reduce the costs and compliance burdens while still achieving the Commission's transparency objectives.

Finally, the Committees caution that the 45 day time limit would be impossible for many advisers, especially smaller advisers who do not have adequate staffing to take on the additional burden, and the information provided in such reporting is likely to be duplicative of other reporting currently provided to investors (and often on a longer time frame), which could lead to confusion. Moreover, some advisers, such as advisers that manage "fund-of-funds," will not have access to all of this information, since many of their private funds indirectly invest in hundreds of portfolio companies, and such advisers would be beholden to the reporting schedules of their underlying investments. Accordingly, the Committees respectfully submit that if the Proposed Rule were to be adopted, then these portfolio companies should be excluded from the definition of portfolio investment for these advisers.

c) Calculations and Cross References to Organizational and Offering Documents

Under the Proposed Rules, advisers would need to provide prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated, as well as cross references to the relevant sections of the private fund's organizational and offering documents that set forth the calculation methodology.

For similar reasons discussed above, the Committees respectfully suggest that if the Private Fund Proposal is adopted, advisers should only be required to provide cross references to the relevant sections of the private fund's organizational and offering documents (*i.e.*, identifying the relevant document and page or section number), rather than cross references and disclosure. The rationale is that such disclosure would be duplicative of information already included in the private fund's documents. Such a change would reduce the burden of compliance with the Proposed Rule while still achieving the Commission's objective of helping to ensure that advisers properly allocate and calculate fees and expenses.

2. Performance Disclosure

The Proposal would also require registered private fund advisers to provide investors with standardized performance disclosures within 45 days after the end of each quarter. In the Release, the Commission emphasized that "it is essential that quarterly statements include performance in order to enable investors to compare private fund investments and comprehensively understand their existing investments and determine what to do holistically with their overall investment portfolio", indicating that such standardized reporting would allow an investor of a liquid fund to determine whether to retain or dispose of its investment and would allow an investor of an illiquid fund to determine whether to invest in other funds managed by the same adviser.[4] The notion that standardized reporting is "essential" (*i.e.*, that the reporting an adviser chooses to prepare is insufficient) assumes both that investors are not capable of deciding the relative value of different investments to their overall portfolio and that true standardization is achievable. Both of these assumptions are flawed, especially in light of the idiosyncrasies of various fund strategies.

The Committees agree that receiving information regarding an investment allows an investor to make decisions about its current and future portfolio; however, the Committees caution against mandating a "one size fits all" approach to reporting. The partnership agreements of private funds typically already provide for robust quarterly and annual reporting. Moreover, as discussed, private fund investors are highly sophisticated, and therefore they are able to (and typically do) negotiate for additional disclosures in addition to the regular reporting the private fund adviser provides to all investors. Of note, investors negotiate for transparency with respect to their particular information needs, ensuring for themselves that they receive the information most useful to them. Moreover, in the experience of the Committee members, specialized reporting requests have increased dramatically over the past 10 years. Such requests are not evidence that existing reporting efforts are insufficient or unclear, but rather, they prove that there is no singular approach to reporting that could possibly satisfy the needs of all investors. Investors have differing views as to what information, if any, would best help them analyze the performance of their investments, and they are best equipped to determine what information they want and/or need. If an investor is not satisfied with the type or extent of performance information a private fund adviser has already provided, the investor may request alternative or supplemental information and, if not entirely satisfied, may elect not to invest in a particular fund. The Committees believe that investors will continue to press for what they need, regardless of whether this aspect of the Proposed Rule is adopted or not.

In addition to regular reporting to current investors, prior performance information is an existing and virtually universal feature of advertising materials, which are already subject to

[4] Private Fund Advisers Release, at 55.

comprehensive regulation under Rule 206(4)-1 of the Advisers Act.[5] Mandating specific performance information in quarterly reporting that may differ from the performance information used by the same adviser in marketing materials (*i.e.*, that the adviser has determined to be useful information for investors in connection with making an investment decision) provides no demonstrable incremental investor benefit. It would also lead to the peculiar effect that advisers take an inconsistent approach in how disclosures are made to current investors as opposed to how they are made to prospective investors. Additionally, the Committees note that as recently as the December 2020 adopting release for the Marketing Rule,[6] the Commission indicated that it would not prescribe any particular performance requirements because "prescribing the calculation could unduly limit the ability of advisers to present performance information that they believe would be most relevant and useful" given the variation among types of advisers and investments.[7] The Committees are confused as to how the Commission could reach such a conclusion in the context of the Marketing Rule, but reach essentially the opposite conclusion in the context of this proposed quarterly reporting requirement.

Requiring standardized quarterly performance reporting would create an overly broad solution where there is no meaningful problem to solve in the first place. As indicated above, private fund advisers already provide their investors with relevant performance information on a regular basis as the governing documents of private funds typically require quarterly and annual performance to be reported to all investors. There is no reason to believe that "standardized" reporting will be any more useful to investors than the reporting advisers already produce for their investors. In addition, many investors require advisers to provide performance reporting via the Institutional Limited Partners Association ("**ILPA**") standardized reporting template (although, even there, most investors have developed their own bespoke form of reporting, in addition to the ILPA standardized reporting). This demonstrates that investors have already rejected standardized reporting as a rule (and further demonstrates that standardized reporting is likely to continue to be viewed by most as insufficient). Accordingly, the standardized reporting prescribed by the Proposal will likely only be supplemental to the various versions of reporting required from investors, as opposed to replacing such required reporting and, as a result, the Proposal would mandate additional expense for investors to produce information they have already said they will not use.

The Commission recognized in the Proposal that there are various approaches to reporting private fund reporting depending on the characteristics of the private fund, but suggested that such

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[5] The Committees note that the Proposal states that "[t]he proposed rule would only require an adviser to disclose gross performance measures for the realized and unrealized portions of the illiquid fund's portfolio. We believe that calculating net figures could involve complex and potentially subjective assumptions regarding the allocation of fund-level fees, expenses, and adviser compensation between the realized and unrealized portions of the portfolio". In the Marketing Rule, however, the Commission "require[s] presentation of net performance information whenever gross performance is presented" which could include instances when only portions of a portfolio's performance are depicted (for instance, the performance of individual portfolio investments within a larger portfolio). The Committees urge the Commission to harmonize this aspect of the Marketing Rule to the Commission's views under the Proposal, by clarifying that a similar approach can be taken with respect to advertisements under the Marketing Rule. The Committees urge this given that the Commission itself has now conceded that there are certain instances where requiring the presentation of net performance is impracticable.

[6] Investment Adviser Marketing, Release No. IA-5653 (Dec. 22, 2020).

[7] *Id.*, at 170.

differences may be misleading without the benefit of well-disclosed assumptions.[8] Indeed, any performance information can be misleading without the benefit of well-disclosed assumptions. However, that is an argument for appropriate disclosures and not for standardization. The Commission additionally states that an adviser would remain free to include other performance metrics in the quarterly statement so long as the quarterly statement presents the metrics prescribed by the Proposal and complies with the other requirements of the Proposal.[9] The Committees caution that this will ultimately lead to multiple versions of performance metrics, which will undo the desired benefits, if any, of standardized reporting in the first place and defeat the purpose of the Proposal.

The standardized performance metrics required under the Proposal would also result in confusing (and potentially meaningless) data being provided to investors as a result of the Proposal's oversimplification of the various types of fund strategies operating within the market. In particular, the Proposal assumes that reporting requirements would only be different as between "liquid funds" and "illiquid funds." There are numerous funds that do not easily fit into either of these categories. For example, there are funds that are structured to provide investors limited liquidity (*e.g.*, no voluntary redemptions, capital drawn down over time, limited life), but that invest in liquid assets. There are also funds that provide investors with liquidity at the fund level, but invest in illiquid assets, *e.g.*, long-term and so-called evergreen funds. Certain funds that invest primarily in illiquid assets may from time to time hold derivatives positions for hedging purposes (and not to generate returns), which would appear not to qualify under the sixth prong of the new definition of illiquid. There are also funds that have liquidity generally at both the fund and asset level but limit investor liquidity with respect to illiquid assets by creating so-called "side pockets". There are numerous other examples of these hybrid funds.

As a result, certain funds for which IRR and MOIC reporting would otherwise be more relevant for investors will now be required to report total net returns (and *vice versa*), which will undoubtedly be more confusing to investors than helpful. The Committees note also that investors in a "hybrid" fund who are accustomed to seeing a certain type of reporting (*e.g.*, IRR and MOIC) would receive a different type of report under the Proposed Rule. The Commission acknowledges in the Release that there are funds that would not fit into either category, but does not offer accommodation to deviate from the strict definition imposed.[10] Consequently, many private fund advisers are likely to struggle with determining the applicable reporting framework to use for funds that do not neatly fit into either category, and the arbitrary delineation between "liquid funds" and "illiquid funds" will likely confuse reporting rather than lead to clearer results. As a result, the standardized reporting prescribed by the Proposal may ultimately have the opposite effect of the Commission's stated purpose (in which case, requiring standardization would have simply created an additional administrative burden on the adviser, without any identifiable benefit to investors). Thus, if quarterly performance reporting is mandated, the final rule should provide advisers with the ability to determine which performance metrics are the most appropriate to disclose to investors in order to provide investors with meaningful information. Alternatively, the Commission could allow funds with "hybrid" characteristics to select the performance reporting required of liquid funds or illiquid funds, but disclose to investors the reasons for that choice.

[8] Private Fund Advisers Release, at 56.
[9] Private Fund Advisers Release, at 58.
[10] Private Fund Advisers Release, at 60.

In addition, the requirement to disclose performance information without the use of subscription lines will obscure material information from investors. In justifying the Private Fund Proposal, the Commission suggested that IRRs showing the impact of subline leverage could mislead investors because the method of calculation could "increase performance metrics artificially".[11] To be clear: leverage does not artificially increase performance; subscription lines are an investment tool (initially advocated by a large segment of the investor population) used to actually improve performance. An adviser's ability to efficiently use a subscription line is an important benefit for private funds and their investors because it allows investors to manage their own liquidity and maximize the returns of their capital by deploying it in other investments. Performance that accounts for the use of a subscription line represents the true investor experience, as it is based on the actual dates that capital is called from investors rather than the (generally earlier) dates on which a subscription line was drawn down. Consequently, reporting performance information without the effect of a subscription line will not align with actual investor experience. Moreover, by mandating such disclosures, the Commission would be requiring advisers to calculate hypothetical performance information on a quarterly basis in order to "standardize" private fund reporting. It is the view of the Committees (and we assume the Commission)[12] that hypothetical performance is usually more likely to mislead investors as it does not represent actual performance achieved.

Given the myriad of nuances to performance calculations, true standardization is not likely achievable. For example, performance information can be calculated reflecting (or ignoring) the impact of "recycling" or bridge investments as well as a number of other variables. Even if all relevant variables to consider in calculating performance information could be identified, it would be challenging to create standardized assumptions for each of these variables that would result in a meaningful comparison across funds. As is the case with fund-level borrowings, these variables are the result of differences in strategies and investment techniques utilized by different private funds. Therefore, mandating standardized reporting that requires the utilization of pre-identified assumptions would result in a comparison of funds that obscures the differences between funds rather than highlights those differences. Instead of creating categories of funds and dictating the disclosure of specific performance metrics for each category of funds, the Committees suggest that the Commission permit advisers to report performance information that the adviser believes are most appropriate, including, for example, the performance metrics used when marketing the fund and disclosing the criteria and assumptions made when calculating such performance. Only by requiring greater transparency from advisers with respect to the assumptions they have used and the effects of such assumptions on performance calculations will the Commission's objectives be satisfied. In addition, requiring that performance be reported based on certain pre-determined assumptions (such as the assumption that subscription line borrowing was not utilized) will only incentivize advisers to employ other strategies and investment techniques to improve performance

[11] Private Fund Advisers Release, at 68–69. The Committees take issue with the description of subscription line borrowing as "leverage". Subscription line borrowings are not "leverage" in the traditional sense (meaning, using debt to buy more assets in order to amplify the returns over a smaller equity base). Subscription line borrowings are secured, on a dollar-for-dollar basis, but unfunded commitments that replace such borrowings, but at a later point in time. As such, they are "equity bridges" as opposed to "financial leverage".
[12] See Investment Adviser Marketing, Release No. IA-5653 (Dec. 22, 2020), at 201 (noting "we believe that such presentations in advertisements pose a high risk of misleading investors since, in many cases, they may be readily optimized through hindsight").

(such as increasing recycling, bridge financings or employing “asset-level” or so-called “back leverage”), the effects of which may be no less confusing or potentially misleading to investors.

Each additional data point proposed to be provided to investors as part of standardized reporting has the potential to confuse investors. For example, the Proposal would require separate disclosures of gross IRR and MOIC for the realized portion and the unrealized portion of an illiquid fund’s portfolio. It is not clear whether any logical conclusions can be drawn from reporting realized and unrealized performance separately. In the Release, the Commission suggests that if the performance of an unrealized portion of an asset is significantly higher than the realized portion, it may imply that the adviser’s valuations are overly optimistic. However, another simple explanation would be the increase in value of the investment retained by the fund following the disposition (which is entirely plausible if two business divisions are more valuable separated from each other than they are as part of larger conglomerate). While this information could be readily presented to investors, these data points would be provided in addition to the net MOIC, the net IRR, the gross MOIC, and the gross IRR — all presented without the impact of a subscription line. And, as discussed above, because investors find relevant the actual performance calculations that account for the use of a subscription line, the same MOIC and IRR data points would likely be duplicated with the impact of a subscription line. The sheer number of data points that would be ultimately provided are much more likely to confuse investors than allowing each adviser to report on the metrics that are applicable to a particular fund with well disclosed assumptions. The Commission also explained that there is a conflict of interest in calculating unrealized value because the adviser may be evaluated and possibly compensated based on unrealized performance, creating an incentive for the adviser to inflate the value of performance. The Commission’s concern, however, would be better addressed by requiring advisers to adopt robust valuation policies, which most advisers already have. Similarly, the Proposal would require the disclosure of such metrics since inception, with the Commission noting in the Release that the since inception reporting requirement would prevent advisers from only including recent performance results or only periods with strong performance.[13] While this reasoning makes sense with respect to disclosure of performance information in advertising materials, in ongoing reporting, providing since inception performance is likely to mask actual changes in performance from quarter-to-quarter. In addition, the requirement for liquid funds to report the one-, five-, ten- calendar year periods will provide data to investors that the Commission recently acknowledged in the Marketing Rule was not useful information for private funds.[14]

The Proposal would also require quarterly statements to be prepared and delivered within 45 days of the end of each calendar quarter, with the prescribed performance metrics required to be provided through the end of the calendar quarter covered by the statement.[15] However, the Commission acknowledges in the Release that this may not be possible and accepts that the prior quarter performance information would need to be provided.[16] This 45-day reporting period is likely impractical for most advisers to comply with, especially with respect to year end reporting. As a result, certain advisers may choose to provide stale reporting in order to be able to comply with the timing restrictions of the Proposal as contemplated by the Commission. For secondary

[13] Private Fund Advisers Release, at 68–69.
[14] Investment Adviser Marketing, Release No. IA-59653; File No. S7-21-19 (Dec. 22, 2020), at 182.
[15] Private Fund Advisers Release, at 68.
[16] Private Fund Advisers Release, at 68.

sponsors, for example, the 45-day requirement would be almost impossible to comply with as these advisers rely on receipt of underlying information from underlying funds who in turn rely on timely receipt of information from portfolio companies. It is reasonable to think performance information that is three months stale within 45 days of quarter end is less useful (and potentially more misleading) than current quarter end information provided within, for example, 60 or 90 days after quarter end. Advisers should have discretion to report beyond 45 days as necessary in light of the character of the fund's portfolio.

Finally, the Committees believe that the net result of these somewhat arbitrary reporting requirements on advisers in an effort to "standardize" private fund reporting will do little more than impose on advisers additional administrative and monetary burdens. These will be either passed on to investors, increasing the expenses borne by investors and reducing their net investment returns, or will be borne by advisers, which would unfairly penalize more modest or leanly-staffed managers, who are less equipped to take on such burdens and costs. Because smaller or emerging advisers do not have the same resources as institutionalized advisers, the Proposal will create additional barriers to entry, which would reduce competition among private fund advisers as well as investment opportunities for investors. In light of the lack of standardization providing a meaningful benefit to investors as described above, we are of the opinion that these administrative and monetary burdens are not justified.

B. Mandatory Private Fund Adviser Audits

The Proposal would require registered private fund advisers to obtain annual and liquidation audits of the private fund by an independent public accountant. Sub-advisers to private funds would be required to take "all reasonable steps" to ensure that those private funds are audited (*e.g.,* by including a requirement in their sub-advisory agreements).[17] A fund's audited financial statements would need to be distributed to current investors "promptly" after the completion of the audit (with no specific timeframe provided).[18] The independent public accountant performing the audits would be required to notify the Commission (i) promptly upon issuing an audit report to the private fund that contains a modified opinion and (ii) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.[19]

1. Unnecessary Overlap with Rule 206(4)-2 (the "Custody Rule").

The Committees agree that private fund audits can be a valuable tool to provide transparency and accountability to private fund investors, protect against misappropriation of funds and provide a check on an adviser's valuation of private fund assets. However, these policy objectives are already achieved by the existing Custody Rule, and the imposition of overlapping and inconsistent standards does not serve to increase investor protection.

Under the Custody Rule, the overwhelming market practice is for private funds to be audited annually and at liquidation, suggesting that current rules and market dynamics are effective. Advisers that do not currently subject some of their private funds to audits do so under

[17] Private Fund Advisers Release, at 112–13.
[18] Private Fund Advisers Release, at 108–09.
[19] Private Fund Advisers Release, at 111.

the explicitly permitted exceptions in the Custody Rule, for *bona fide* and well understood business rationales such as (i) private fund investors negotiating to have either a surprise exam or a non-custodial management agreement to avoid the costs of an audit (which can be substantial), particularly in the case of co-investment vehicles, other small funds, and funds in liquidation, (ii) non-U.S. funds that are subject to a non-GAAP audit or other non-GAAP accounting standards, which cannot be easily reconciled to GAAP, being subjected to a surprise exam in order to avoid duplicative GAAP financials that are not meaningful for non-U.S. investors, (iii) in the asset-backed securitization market, discretion over private fund cash and securities resting exclusively with a third party trustee or collateral agent who generally also meets the requirements of a qualified custodian, and (iv) smaller advisers finding the cost of annual audits prohibitive or having limited access to auditors meeting the necessary independence standards. Overly prescriptive provisions, even where the overarching topic is one of general agreement, can be harmful and have unintended consequences. The Proposal would eliminate the limited but important flexibility that is currently available to advisers and investors and that the Commission has recognized as appropriate in the existing Custody Rule. The Committees do not believe there is a policy rationale or demonstrated investor-protection need to have a different outcome in the Proposal. Moreover, these proposed changes, like the proposed changes discussed above, would significantly increase the cost of compliance — a cost that is ultimately borne by, and reduces the returns of, investors — without added protection.

The Staff have requested comment with respect to whether compliance with the Custody Rule should result in compliance with the new audit requirement.[20] In particular the Staff have requested comment on the timing for delivery of audits under the Proposal, and whether it should be within the 120-day period allowed under the Custody Rule.[21] The Staff have also requested comment regarding whether "liquidation" should be defined for purposes of the audit requirement.[22] The Committees believe that compliance with the Custody Rule should – in all respects – result in compliance with the new audit requirement, including the timing for delivery and how "liquidation" is interpreted under the two rules. More generally, the Committees feel that any outcome other than alignment between the Custody Rule and the Private Fund Proposal would produce unwarranted confusion among market participants and increased compliance costs without added investor protection. It is simply inefficient to have two rules that so heavily overlap but diverge in key respects, and compliance with two differing regimes would increase compliance costs and reduce returns to investors. Divergence would also create confusion regarding the application of current Custody Rule FAQs, guidance, and no-action letters to audits under the Proposal, such as the current relief from the 120-day delivery requirement for funds of funds.[23] If there are elements to the Custody Rule that the Commission believes warrant amendment, the Committees urge the Commission to set forth a proposed amendment to the Custody Rule for review and comment in accordance with the Administrative Procedure Act. If not, the current timeframes and other provisions under the Custody Rule should apply in both instances. Similarly, "liquidation" is not currently defined for purposes of the Custody Rule, and there has been no suggestion or evidence that the Custody Rule's requirements relating to liquidation are being

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[20] Private Fund Advisers Release, at 114.
[21] Private Fund Advisers Release, at 117-118.
[22] Private Fund Advisers Release, at 119.
[23] Staff Responses to Questions About the Custody Rule, available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm (hereinafter, the "**Custody Rule FAQ**")

abused based on the lack of a definition. Therefore, there is no basis for removing flexibility for advisers during liquidation under the Proposal. While the Proposal posits that management fees may be calculated based on a *de minimis* amount of assets during liquidation,[24] the asset base for the calculation of management fees is a matter of negotiation between an adviser and investors, so it is unclear why the Commission would need to "detect" this through additional restrictions on liquidation audits.

2. The Proposed Scope of the Audit Requirement Should Not Be Expanded

As proposed, the audit requirement would only apply to registered advisers with respect to 3(c)(1) and 3(c)(7) private fund clients. This is consistent with the current scope of entities being audited under the Custody Rule and the longstanding expectations of market participants. The Staff have requested comment with respect to whether (i) the audit requirement should be extended to exempt reporting advisers ("**ERAs**") and other private fund advisers[25] and (ii) the existing relief for non-U.S. clients of non-U.S. advisers ("**Offshore Funds**") from the "substantive" requirements of the Advisers Act should apply to exempt such Offshore Funds from the new audit requirement.[26] If the audit requirement is maintained, the Committees believe that including ERAs and Offshore Funds — both groups that are currently exempt from the application of the Custody Rule — within the scope of the audit requirement would upend the long standing expectations of both advisers and investors, imposing new compliance costs on investors and eliminating the ability of such investors to negotiate for the reporting that is most meaningful to them.

ERAs are generally smaller advisers with a smaller pool of private fund clients and investors. The costs of an annual audit would have a significant impact on the business of such ERAs, as well as being disproportionate to the assets under management of the smaller funds ERAs generally manage. Small ERAs are also less likely to have access to auditors meeting the independence requirements of the Proposal. Finally, because many ERAs serve a smaller pool of investors, such investors are well placed to negotiate the accountability and reporting that are meaningful to them, without being subject to mandatory audit provisions.

Additionally, the audit requirements pose an undue burden on non-U.S. advisers and Offshore Funds, and will inevitably prejudice certain jurisdictions. Offshore Funds may be subject to local law requirements to produce non-GAAP financials, or such financials may be the most meaningful option for non-U.S. investors. Similarly, not all local accounting standards are easily reconcilable to GAAP, meaning advisers in those jurisdictions would be required to produce two sets of audits. The availability and cost of auditors who will satisfy the Proposal's requirements will also differ by jurisdiction.

The current Custody Rule regime (allowing surprise exams instead of audits and exempting Offshore Funds and ERAs) recognizes the different business model for ERAs and alleviates the challenges faced in non-US jurisdictions. Moreover, there is no evidence that it is being abused or otherwise deficient from an investor protection standpoint.

[24] Private Fund Advisers Release, at 119-120.
[25] Private Fund Advisers Release, at 114.
[26] Private Fund Advisers Release, at 134-135.

3. Responses to the Staff's Requests for Comment

While the Committees believe that investors and advisers would be best served by continuing to rely on the existing audit provisions of the Custody Rule, the Committees have the following responses to the Staff's other requests for comment:

a) Full or Partial Exceptions, *de minimis* Thresholds and Grace Periods

Existing exceptions under the Custody Rule should continue to apply to the audit requirement, as the policy rationale for those exceptions has not changed and, as discussed above, advisers have spent considerable time and resources building compliance programs around the existing Custody Rule audit requirements. There is no evidence that these exceptions are being abused or are otherwise deficient from an investor protection standpoint.

With respect to the proposed *de minimis* thresholds for assets under management and the number of investors in a private fund,[27] the Committees support these proposals as such thresholds would help reduce unnecessary compliance costs by avoiding audits of zero or near-zero balance sheets and preserve investor negotiating power in smaller funds and co-investment vehicles to reduce their costs and tailor reporting requirements to their particular needs. The same is true of the suggested grace periods and reduced audit requirements for "stub" months immediately following a fund's formation (which the Private Fund Proposal carves out of the quarterly statement requirement) and the period during which a fund is in liquidation.[28] Any irregularities in either period would be captured in the next duly required audit. Finally, the Committees also support the proposed exemption for clients that pay *de minimis* advisory compensation,[29] since the policy rationale for the audit requirement in the Proposal rests on the risk of inflated valuations for fees, which does not exist if the vehicle pays only *de minimis* compensation.

The Staff have asked if a flexible delivery standard should be adopted with respect to the delivery of audits, instead of the "promptly" standard in the Proposal (which the Staff have interpreted in other contexts to mean 45 days) or the 120 days required by the Custody Rule.[30] The Committees support a more flexible standard without any specific distribution deadline.[31] As the Staff have already acknowledged with respect to the financial statements of funds of funds,[32] there are often operational constraints on an adviser's ability to collate underlying data for a fund audit which require an extended audit period, particularly where funds are in a more complex structure of feeders, secondary funds, co-investment vehicles and other alternative investment vehicles ("**AIVs**"). With the expected volume increase for auditors as a result of the Private Fund Proposal, these operational constraints will likely be compounded. Advisers should therefore have the flexibility to deliver audits in a timeframe that is appropriate for their business, the abilities of their auditors, and the needs of their investors.

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[27] Private Fund Advisers Release, at 115.
[28] Private Fund Advisers Release, at 118-119.
[29] Private Fund Advisers Release, at 115.
[30] Private Fund Advisers Release, at 117-118.
[31] The Committees believe that a similar, more flexible standard using "promptly" should also apply to the delivery requirements under the Custody Rule.
[32] The Custody Rule FAQ.

With respect to all of the proposals above, the Committees note that maintaining consistency with the audit requirement under the Custody Rule would be a paramount concern however, and so for any relief to be meaningful it would also need to be applicable under the Custody Rule.

b) Consolidated Financials

The final rule should clarify that the audited financials provided to investors can be consolidated financials, *i.e.*, that intermediate structuring vehicles, portfolio company holding companies, and other AIVs may be consolidated with the relevant private fund and should not need to produce separate financial statements, regardless of whether they themselves rely on 3(c)(1) or 3(c)(7) (as most such vehicles do). Doing otherwise would create unnecessary audit expenses without any commensurate benefit to investors, and any irregularities in the valuation of assets in such vehicles by the relevant adviser would be captured in a consolidated audit, satisfying the policy rationale underlying the audit requirement.

c) Additional Filings with the Commission

Financial statements should not be subject to mandatory Commission submissions. The Commission already receives statistical information regarding private fund assets under management and underlying investments via Form PF filings (which are currently proposed to be expanded under the Form PF rule proposal released on January 26, 2022[33]), as well as information regarding auditors on Form ADV. These standardized filings are the most appropriate and efficient method for the Staff to collect statistical data. The non-standard format of financial statements makes it difficult to process them using automated tools, and they are therefore most useful when reviewed as part of a more fulsome examination or other fact-finding exercise. Submission of audited financials would also disclose the identity of service providers, portfolio companies and financing partners who are not currently subject to regular disclosure. If the Staff intend to extend their authority to require disclosure of such parties, the Commission should set forth a proposed amendment for review and comment in accordance with the Administrative Procedure Act. Finally, the policy rationale for the audit requirement is protection of investors against managements fees calculated on inflated valuations. Submitting financial statements to the Commission would not meaningfully help the Staff monitor for this. Instead, the Commission's processing costs for the volume of financial statement submissions that would be received is likely to far outweigh any benefit.

Similarly, the Committees believe the Staff will receive limited benefit from requiring auditors to report modified opinions and terminations of the audit relationship to the Commission. Modified opinions are already reported on Form ADV promptly upon receipt, and there is no evidence that this system has been subject to widespread false reporting. Similarly, unlike the auditor for a surprise examination who may be terminated at any time during the financial year (and whose termination is therefore more meaningfully subject to prompt reporting on Form ADV-E), a change in a fund's annual auditor is subject to near contemporaneous reporting in Item 7.B

[33] Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, Release No. IA-5950; File No. S7-01-22 (Jan. 26, 2022). The Committees note that the Committees submitted to the Commission a comment letter regarding this proposal on March 21, 2022.

of Form ADV at the end of the fund's financial year, when the audit is completed. In addition to generating a considerable volume of new communications for the Staff to process, requiring an auditor to report, via a confidential email to the Department of Examinations, any adviser who terminates or removes such auditor from consideration for reappointment fundamentally alters the market dynamics between advisers and auditors. With the fluctuations in the auditor market that the adoption of the Proposal is likely to cause, it is to be expected that increased demand will cause auditors to raise rates and adopt less favorable contractual terms. Advisers must be free to "walk away" from such negotiations without fear of being reported to the Commission and suffering increased examination risk where they determine it is in the best interest of investors to do so.

d) Preserving Investor Flexibility

The Staff has sought comment on several alternative formulations of the proposed audit rule, such as permitting audits less frequently than annually or allowing advisers to substitute annual audits with reporting and examinations.[34] As discussed above, the Committees believe that it is essential that the audit requirement and the Custody Rule remain consistent, so in order for any alternate proposal to be meaningful, such alternatives would need to be extended to the Custody Rule as well. The request for comment also implicitly recognizes that there are a variety of different approaches to transparency and accountability which may be appropriate for a particular fund. Imposing a "one size fits all" audit requirement, particularly without the exemptions and alternate compliance methods currently provided by the Custody Rule, forces what may be unnecessary audit costs on investors and eliminates their ability to negotiate reporting and accountability standards that suit their needs. Therefore, any consideration of alternatives to the proposed audit rule should also consider allowing investors to waive the audit requirement completely (which they may currently do under the Custody Rule by structuring their advisory relationships to avoid adviser custody). The Committees note that, even in the absence of an audit, with the new quarterly statement requirement, private fund investors will be receiving mandatory granular information regarding fund holdings and asset valuations, fees and expenses on an ongoing and timely basis, which addresses many of the policy concerns underlying the proposed audit requirement. With this new information available, investors should have the option to forego costly audits where doing so is in keeping with their investment and oversight requirements.

C. Adviser-Led Secondaries

The Private Fund Proposal would require an adviser to obtain a fairness opinion in connection with certain adviser-led secondary transactions where private fund investors typically have the option to sell their interests in the private fund or to exchange them for new interests in another vehicle advised by the adviser. The Commission believes that this would provide an important check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors.[35] As demonstrated below, however, the Committees believe that requiring a fairness opinion in connection with adviser-led secondary transactions would be, under certain common circumstances, detrimental to private fund investors. Specifically, obtaining a fairness opinion may entail significant costs, which would ultimately be borne by the private fund investors. As described below, there are also

[34] Private Fund Advisers Release, at 119.
[35] Private Fund Advisers Release, at 122.

other price transparency mechanisms that provide private fund investors with protection. The Committees therefore respectfully recommend that the Commission should not adopt a rule requiring that the adviser obtain a fairness opinion prior to the completion of an adviser-led secondary transaction and that, if adopted, such a rule be subject to the exceptions and modifications discussed herein and enumerated below.

Adviser-led secondary transactions provide important benefits to private fund investors. First, adviser-led secondaries often provide investors with the option to obtain liquidity or to remain exposed to the asset(s) for a longer period of time. When considering the relatively long holding periods associated with private fund investments, most private funds are limited life entities and they are not designed to hold investments indefinitely. Adviser-led transactions provide investors with an option to remain invested in such assets beyond the ordinary life cycle of the private funds in which they invest. In addition, certain portfolio companies can change their investment characteristics and, therefore, while still suitable for certain investors, these investments might be better held by a different investment vehicle. Unlike a sale to a third-party, an adviser-led secondary transaction offers each investor the flexibility to determine for itself whether it wishes to continue to be exposed to the investment, despite the change in its investment characteristics, or to obtain liquidity, which is not something a traditional sale to a third-party would offer. Finally, adviser-led secondary transactions provide for efficiencies in the market. Instead of selling the portfolio company or companies to a third-party private equity manager (*i.e.*, one that has no prior knowledge of the portfolio company or companies or their respective management teams) with associated tax leakages, the adviser continues to manage and advise the company or companies and their respective management teams while the investor base can adjust in accordance with its preferences at reduced tax cost. For portfolio company management teams who need additional capital and/or time to further execute their growth strategy, adviser-led secondary transactions can provide them with such opportunity.

The Committees also note that ILPA recognized the benefits of adviser-led secondaries to private fund investors, and in its considerations relating to GP-led Secondary Fund Restructurings published in April 2019 (the "**ILPA Report**"), noted that "selling Limited Partners may benefit from an independent assessment of the value of the underlying portfolio, together with a formal opinion stating that the cash price offered is fair from a financial point of view" but did *not* require a fairness opinion in all adviser-led secondary transactions.[36] In fact, if adopted, Proposed Rule 211(h)(2)-2 would be the first and only federal securities law rule requiring a fairness opinion. Neither Item 1015 of Reg. M-A or any other provision of the Securities Act of 1933 or the Securities Exchange Act of 1934 including Section 13(e)(3), or the rules and regulations promulgated thereunder (nor for that matter FINRA Rule 5150) require a registrant or other person to obtain a fairness opinion in connection with an M&A transaction.

In addition to the foregoing, the cost of obtaining a fairness opinion can be substantial and unnecessarily drive up the cost burden of private fund investors when pursuing adviser-led secondary transactions. Furthermore, requiring a fairness opinion in connection with certain adviser-led secondary transactions can be problematic where financial aspects of the transaction are not susceptible to financial analyses or information necessary to render such opinion is not

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[36] *See* https://ilpa.org/wp-content/uploads/2019/04/ILPA-Guidance-on-GP-Led-Secondary-Fund-Restructurings-Apr-2019-FINAL.pdf

available or disproportionately expensive to obtain and could impair the ability of funds and their investors to engage in otherwise desirable and beneficial transactions. For example, the definition of fairness opinion included in the Release ("Fairness opinion means a written opinion stating that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair")[37], like the ILPA Report, focuses on "price", as if adviser-led secondary transactions are exclusively "cash" transactions when many (if not most) of the adviser-led secondary transactions contemplated by the Release involve an exchange of "value" by fund investors (an exchange with investors of securities in a new fund for securities in an existing fund) and not merely the sale of assets by a fund for cash. For adviser-led secondaries transactions involving an exchange of securities, the financial analyses necessary for purposes of valuing the securities in a new fund to be received by existing fund investors can be particularly problematic (if not impossible) where the new fund has not completed its fund raising and/or is not yet fully invested in the securities it will hold. The Committees believe that any rule requiring that the adviser obtain a fairness opinion prior to the completion of an adviser-led secondary transaction should include a "safety valve" permitting adviser-led secondary transactions to be completed without the adviser obtaining a fairness opinion where obtaining an opinion is sufficiently problematic or costly given the nature of the transaction and the availability, nature and cost of the information that would be required by the fairness opinion provider in order to render a fairness opinion.

Finally, the Committees do not believe the Release reflects an appreciation of certain core aspects of fairness opinions: (i) the purpose of obtaining a fairness opinion; (ii) who is entitled to rely on a fairness opinion; or (iii) the contractual limitations fairness opinion providers typically insist upon in an effort to circumscribe their potential liability. Fairness opinions are obtained by and addressed to clients and/or their fiduciaries to assist them in fulfilling their fiduciary duty of care in deciding whether the client should engage in or the client fiduciary should recommend a transaction. To avoid potential liability to investors, fairness opinions are explicitly not addressed to or otherwise intended as advice to investors. Additionally, in their engagement letters, fairness opinion providers limit their potential liability to their clients and their fiduciaries through carefully crafted contractual releases and exculpation provisions. Lacking privity of contract, such limitations on liability would not generally be binding on investors who, under the Commission's Proposed Rules regarding fairness opinions, would, it appears, be able to rely upon a fairness opinion as if commissioned by and addressed to them. Given the potential size of adviser-led secondaries transactions and associated risks, the limitations on liability typically required by opinion providers are essential to protect against potential liabilities for mere negligence that could dwarf the balance sheets of many opinion providers, significantly reducing the availability and increasing the cost of obtaining such opinions.

In light of the benefits that adviser-led secondary transactions provide to private fund investors, coupled with the meaningful costs associated with obtaining a fairness opinion and other issues identified above, the Committees believe that the Commission should not adopt a rule requiring that the adviser obtain a fairness opinion prior to the completion of an adviser-led secondary transaction and that, if adopted, such a rule be modified to address the concerns above and subject to the following exceptions.

[37] Private Fund Advisers Release, at 332 (Private Fund Proposal §275.211(h)(1)-1 (emphasis removed)).

1. Investor Consent

Under certain circumstances, private fund investors would find limited or no value in a fairness opinion. This is often the case when the secondary buyer(s) have priced the applicable asset(s) at or above its current mark. In addition, the private fund may have a single or a concentrated number of investors, who can evaluate the portfolio company as well as, or better than, a third-party opinion provider. And in other circumstances, private fund investors may prefer liquidity in the form of an adviser-led secondary transaction over a sale to a third party, for the benefits described above and may not be interested in, or it may not be commercially reasonable to obtain, a fairness opinion. Additionally, when the purchase price for the investments is below the fair market value (and therefore a fairness opinion cannot be obtained), fund investors should still have the right to waive the requirement for a fairness opinion in order to be able to obtain liquidity. Accordingly, it is the Committees' view that obtaining a fairness opinion should not be a compulsory condition to completing an adviser-led secondary transaction, but rather, a protection that private fund investors or the limited partner advisory committee of a private fund should in their judgment have the option to request.

2. Competitive Sale Process

A fairness opinion is not the only way to validate pricing. A competitive sale process, conducted by an independent advisory firm with multiple third-party bids, also provides an assurance as to the fairness of the price of an adviser-led secondary transaction. While such competitive sale processes may only include offers to purchase the assets through a vehicle managed by the adviser, that does not necessarily suggest a lower price and a fairness opinion is often based on a range of values. Requiring a fairness opinion under such circumstances would not be value additive and would only increase the costs borne by private fund investors. Therefore, a fairness opinion should not be required for adviser-led secondary transactions priced out of a competitive sale process that are conducted by an independent advisory firm with multiple third-party bids.

3. Tender Offers

The Commission states that the proposed definition of an adviser-led secondary transaction would capture "tender offers."[38] In a tender offer, a private fund investor that does not wish to participate in the offer substantially maintains its status quo in the private fund. Therefore, the risk that the Commission identified as "an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors"[39] is generally not applicable in a tender offer. Further, in most cases, private fund investors will be offered the protections of Section 14 of the Securities Exchange Act of 1934 and pursuant to the regulations promulgated thereunder.[40] Accordingly, the Committees respectfully submit that tender offers should be excluded from the requirement to obtain a fairness opinion.

[38] Private Fund Advisers Release, at 124.
[39] Private Fund Advisers Release, at 122.
[40] *See Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979).

4. Third-Party Valuations

Certain private funds distribute to their investors third-party valuations on a regular basis in accordance with the constituent documents of the private funds. In the absence of any material changes, an adviser should be able to utilize the most recent valuation conducted by an independent opinion provider for purposes of pursuing an adviser-led secondary transaction without obtaining a separate fairness opinion, even if such valuation was not conducted with respect to such adviser-led secondary transaction, and without a separate fairness opinion. It is the Committees' view that any such third-party valuations conducted within twelve months[41] prior to initiation or "decision time" of the transaction should be a reliable indicator of valuation, provided that the adviser also provides its private fund investors the summary of any material business relationships with the independent valuation provider, as required under the Proposal.

5. Prior Sales

Adviser-led secondary transactions that are priced based on a recent sale of the portfolio company by the adviser or other shareholders of the portfolio company to a third-party should not require a fairness opinion because the recent sale to a third-party provides assurance as to the fairness of the price to private fund investors. Requiring a fairness opinion under those circumstances will cause an unnecessary expense to private fund investors without providing much additional information. Therefore, in the absence of any material changes, it is the Committees' view that any adviser-led secondary transaction that is priced based on a sale of the same portfolio company to a third-party should not require a fairness opinion, if the sale occurred within twelve months prior to closing of the adviser-led secondary transaction.

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The Committees respectfully suggest that the Commission modify the definition of an adviser-led secondary transaction to read, in the relevant parts, as "any transaction …that offers private fund investors the choice between either (i) selling … or (ii) converting or exchanging …", as opposed to "any transaction … that offers private fund investors the choice to: (i) sell … or (ii) convert or exchange…" The Committees believe that this change would clarify the Commission's intent to capture secondary transactions that may not involve a cross sale between two vehicles managed by the same adviser.

The Proposal also requires an adviser to provide the fairness opinion and the written summary of the material business relationships between the adviser (and its related persons) and the independent opinion provider "prior to closing of the adviser-led secondary transaction."[42] The Committees note that typically investors exercise their elections with respect to an adviser-led secondary transaction ahead of the closing of the transaction. The Committees recommend that to the extent private fund investors need to exercise their elections (either to sell or "roll"/"reinvest") with respect to an adviser-led secondary transaction prior to the closing of the transaction, the adviser should be required to distribute any required disclosures on or prior to the election due date.

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[41] The Committees note that a twelve month timeframe would allow the use of regular annual valuations done for equity plan purposes.

[42] Private Fund Advisers Release, at 340 (Private Fund Proposal §275.211(h)(2)-2).

D. Prohibited Activities

As discussed above, as a general matter, the Committees believe the Commission's current/historical approach of requiring more and clearer disclosure is a better way to protect investors' interests than adopting a "one size fits all" prescriptive approach of prohibiting certain specified contract terms in arrangements between private funds and sophisticated parties. In the context of prohibited activities, the Committees respectfully suggest that the Commission should consider requiring clear empirical disclosure of certain fee and expense provisions and practices as an alternative to mandating that such provisions cannot be agreed to with clients at all. This would accomplish the purpose of highlighting sensitive areas for investors while still promoting the freedom of parties to contract on their investment priorities.

The Committees also respectfully question the Commission's statement that "smaller investors" need special protection from imposition of particular contract terms.[43] All investors in private funds are highly sophisticated financial actors with required investor qualifications that must be adhered to by all fund sponsors. Private fund investors negotiate fund documents extensively, and they are often represented in such negotiations by highly experienced, sophisticated counsel. The terms of private funds are the result of these negotiations and the parties involved are well aware of what has been agreed. In addition, many private funds source capital from one or a few lead investors, whose investment size is substantially larger than many others in the same fund. The terms negotiated by such lead investors often benefit all investors in the fund and tend to become the terms adopted by smaller funds as well.

The imposition of prohibitions on fund fee and expense practices will potentially lead to unintended consequences for all parties involved—including flat management fee rate increases without the transparency of robust expense disclosure, further barriers to entry for new sponsors and diminished flexibility in structuring transactions (which could lead to increased expenses).

The Committees also respectfully submit that applying the proposed contract prohibitions to all advisers to private funds, regardless of their registration status, would be overreaching. For one thing, it will disadvantage all U.S. advisers as compared to non-U.S. advisers in terms of offering the most competitive terms for their products and in terms of overhead and compliance costs. It could potentially result in a flood of talent and capital to outside the United States, as sponsors seek to manage assets in jurisdictions that do not impose arbitrary contract prohibitions on their products. The Proposed Rule also goes well beyond the basic anti-fraud provisions historically applicable to all advisers (regardless of registration status). If the prohibitions are adopted, the Committees respectfully suggest that they should apply only to Commission-registered advisers who have affirmatively subjected themselves to oversight and examination by the Commission. They should also not apply to exempt reporting advisers, who tend to manage smaller funds with fewer assets under management and would disproportionately bear the additional cost of these proposals.

The Committees also believe that the prohibitions outlined in the Proposed Rule should not apply to separately managed accounts (including where such accounts are structured as "funds of one"). The highly-sophisticated counterparties to these arrangements do not need the protection

[43] Private Fund Advisers Release, at 132.

of the Commission in connection with negotiating the terms of their investments. The Committees also believe that the prohibitions should not apply to co-investment vehicles that invest alongside so-called "main funds" that are themselves beneficiaries of the applicable adviser' fiduciary duty. In both cases, the existing anti-fraud rules are more than sufficient to protect investors in such vehicles.

As discussed in the context of other proposals proposed by the Proposed Rule above, the requirement of additional reporting of prohibited activities on top of the prohibitions themselves would create additional burdens on advisers and increase compliance costs substantially. It would be unreasonable to require an adviser to document compliance with *every* prohibited act under the law. This requirement would create further barriers to entry and increase adviser costs, which will ultimately result in higher fees to investors. Increased costs to investors is exactly what the rules are seeking to prohibit. If documentation were required, the Committees respectfully submit that it should only be required on a prospective basis, as advisers will not have systems in place to retroactively re-create this kind of reporting. A memorandum or attestation seems similarly unlikely to achieve the desired end.

1. Fees for Unperformed Services

The Committees understand and are sympathetic to the Commission's desire to stamp-out fee arrangements that compensate advisers for services that were never performed. That proposition, while simple enough to espouse, however, presupposes that the instances in which a fee is based on so-called unperformed services (or those that an adviser does not "reasonably expect" to provide) will always be obvious and self-evident. This assumption does not translate well to complex financial transactions between sophisticated investors. The fact that the Commission previously viewed accelerated monitoring fees as not having been properly disclosed in certain instances, does not support the outright banning of all such fees—or, more specifically, fee arrangements that purport to compensate an adviser before or after the delivery of the service that was the basis for the fee (or arrangements that purport to increase the fee in certain circumstances).

If all such fee arrangements were *per se* fraudulent, then a myriad of bonus, deferred compensation, tail-fee, and other similar arrangements in a multitude of contexts, both within and outside of the Commission's jurisdictional preview, would be outlawed. The Committees believe, however, that so long as the material terms and conditions of any such fee arrangement and its potential to be paid (or increased) in certain circumstances (whether before or after the underlying services have been performed) have been bargained for by the applicable contracting parties, that it would not be for the Commission (or any other regulatory body for that matter) to second-guess the commercial judgment of the parties who agreed to such terms. This would be no more appropriate than it would be for a regulatory body to prohibit the producer of luxury automobiles from charging prices in excess of those charged by lower-cost, mass produced cars. To put it simply: if customers do not want to spend a higher price, they are welcome to seek those goods elsewhere (for a different price and potentially of a different quality). The same logic applies to the market for services for private funds management.

In applying the Committees' concern to the issue of accelerated monitoring fees specifically: when properly disclosed, an accelerated fee arrangement reflects the total economic arrangement between an adviser and a portfolio investment (company) and should be viewed as the total dollar amount that a portfolio company will pay an adviser for the full range of services that the adviser provides over time, not simply fees for future (potential) services. And provided that the applicable documents are clear on their face regarding the material terms and conditions of such fee arrangements and investors are able to assent to those terms and conditions at the time of their investment (or, after the fact through investor or limited partner advisory committee consents), the Committees see no basis for the outright prohibition of this or similar practices. The Committees' views in this regard also extend to private funds with 100% management fee offsets where any excess fees are retained by the adviser where no further management fee offset can be applied and the private fund investors are not offered a rebate or another economic benefit equal to their pro rata share of any such excess fees. Such arrangements are not about so-called unperformed services, but rather, constitute a "higher price" fee arrangement that (if well disclosed) investors should be free to accept or reject (taking into the adviser's track record and other offerings). Saying it differently: the Committees fully support requirements that all such fee arrangements—whether they constitute the acceleration of monitoring fees or the retention of excess fee—be fully and properly disclosed; but the Committees are troubled by the Commission's attempt to outright ban such practices in what should otherwise be a free and open market for investment advisory talent and services.

In addition to the foregoing, the Committees are troubled by any rule that requires an adviser to defend whether or not the services underlying a particular fee arrangement were "reasonably expected" to be provided. Clearly, whether an expectation is "reasonable" is a facts and circumstances proposition and basing any rule on the question of whether an adviser had such a "reasonable expectation" is an invitation for all manner of second-guessing by staff members of the Division of Examinations. These fee arrangements typically last several years, and changed circumstances could convert what was once a reasonable expectation into an apparently unreasonable position, but only with the benefit of 20:20 hindsight. As noted above, the question should not be about whether the provision of the services was reasonably expected or not, or whether or not there is even a service to be provided at all, but rather, whether the fee arrangements—and all of its material terms and conditions—were properly understood and assented to by the applicable investors.

Should the Commission nevertheless move forward with its prohibition on fees for unperformed services, the Committees respectfully ask the Commission to qualify the prohibition as follows: (i) first, such fees should only be prohibited to the extent that the material terms and conditions of such arrangements are not properly disclosed to investors, at or prior to the time of their commitment or investment in the applicable private fund (or, if such fee arrangement is implemented after the fact, with the requisite consent of the investors (*e.g.*, a majority-in-interest) or by the limited partner advisory committee, if any), (ii) such fee practices should be *per se* permitted to the extent that the portion of such fees allocable to the private fund in question offsets any management fees payable by such funds (and, if such funds—such as co-investment vehicles—do not bear management fees themselves or there are no further management fees to offset, such fee practices should be permitted so long as the retention of the allocable amount or excess, as the case may be, satisfies the requirements of the foregoing clause (i)), (iii) investors should be free to waive their right to receive their share of any rebates of portfolio investment fees (whether for tax-related or any other reasons),[44] and (iv) regardless, the language of the Proposed Rule, which currently reads "monitoring, servicing, consulting, or other fees", should be clarified to reference "other *similar* fees"[45] (that is, it should not encompass "all" fees, which could be broader in scope than intended and could capture other legitimate fees that should continue to be permitted).

2. Certain Fees and Expenses

In addition to prohibiting investment advisers to private funds from charging for certain unperformed services, the Private Fund Proposal would also prohibit any investment adviser from charging certain fees or expenses to a private fund (the "**Prohibited Expense Activities**"). Unlike the proposed rules regarding reporting and secondary transactions discussed herein, the Prohibited Expense Activities restrictions would apply to both Commission-registered and unregistered investment advisers. The Private Fund Proposal's rules on Prohibited Expense Activities would bar any investment adviser from directly or indirectly charging a private fund for (i) fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority and (ii) any regulatory or compliance fees or expenses of the adviser or its related persons.

As a preliminary matter, the Committees note that, as discussed in greater detail below, the statutory authority of the Commission for these prohibitions is, at best, unclear. Such prohibitions do not appear to fall within the intended scope and purpose of Section 211(h) of the Advisers Act, as they pertain neither to "sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers" nor to "the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers."[46] As to Section 206(4) as a potential source of statutory authority, the Private Fund Proposal offers no analysis or reasoning as to how the activities covered by the proposed prohibitions are "fraudulent, deceptive or manipulative" or how the prohibitions would reasonably prevent fraudulent, deceptive or manipulative practices.[47] Rather, the Commission simply asserts that it "believe[s] advisers should bear" various compliance expenses that would fall within the Proposed Rule's scope, because the allocation of such expenses "create[s] an incentive for an adviser to place its own interests ahead of the private fund's interests," even where such expenses are fully disclosed.[48] Purportedly in support of this proposition, the Release goes on to state that, "[f]or example, in some circumstances, an adviser *may* charge a fund significant fees and expenses in connection with an investigation that *may not* be in the fund's best interest".[49] The Committees believe, however, that this reasoning is circular and does not advance a rationale as to why charging such fees and expenses to a private fund would, by itself, *be*—or how the prohibition would *prevent*—a fraudulent, deceptive, or manipulative act, practice or course of business. Rather, the

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[44] Private Fund Advisers Release, at 136.
[45] The Committees also note that the Private Fund Advisers Release, at 139, inquired as to whether the waiver by one investor of its share of any rebate of portfolio investment fees should be distributed to the other investors in the fund. The Committees do not understand why other investors should receive a windfall benefit due to the waiver of another investor and fear that sponsors would be disinclined to accept the investments of such investors who are typically tax-exempt.
[46] Section 211(h) of the Advisers Act.
[47] Section 206(4) of the Advisers Act.
[48] Private Fund Advisers Release, at 141.
[49] Private Fund Advisers Release, at 141 (emphasis added).

rationale appears to be the Commission's judgment that fees and expenses "related to forming and operating an advisory business . . . should be borne by the adviser and its owners rather than the private fund and its investors." [50]

To be clear, the Committees agree that there are situations in which the allocation to a private fund of fees and expenses related to an advisor's own compliance and regulatory obligations, or an examination or investigation of the adviser, is not appropriate—most obviously, when such allocation is not clearly disclosed or contractually agreed to by a private fund's investors. And indeed, the vast majority of private fund advisers, in most cases, bear such fees and expenses themselves. However, the Committees believe that the existing practices in the private fund marketplace, and the careful commercial arrangements that are reached surrounding these topics, demonstrate that these issues are nuanced and not appropriately regulated by instituting blanket restrictions.

In the Committees' view, there will always be situations where, in view of the whole commercial context, it is reasonable for an investment adviser to charge a private fund certain fees or expenses that would fall within the scope of the proposed prohibitions. Further, and as discussed further below, as currently drafted the proposed prohibitions would raise substantial questions regarding the classification of many types of fees and expenses that are incurred by private funds and/or their investment advisers in the ordinary course of business. The costs of addressing these questions will not simply be absorbed by advisers to private funds, but instead will result in (i) more complexity in negotiations as parties seek to achieve the same results that they had previously operated under with greater, and yet more ambiguous, constraints, and (ii) higher costs to private fund investors, as the most simple way for advisers to private funds to offset any potential shortfalls caused by the proposed prohibitions will be to raise management fees for all investors across the board.

a) Costs Related to Registration and Regulatory Compliance

The Private Fund Proposal's rules on Prohibited Expense Activities would prohibit an investment adviser to a private fund from charging such fund for "any regulatory or compliance fees or expenses of the adviser or its related persons."[51] According to the Proposal, the Commission "do[es] not anticipate" that this prohibition "would cause a dramatic change in practice for most private fund advisers" that do not utilize a "pass-through expense model." [52] While the Committees agree that most private fund advisers do not use a "pass-through expense model," the Release offers no reason as to why such constructs are so inherently problematic as to warrant their complete prohibition.

It is not, however, the pass-through expense model that, in the Committees' view, is the most concerning aspect (aside from the lack of statutory authority) of the proposed prohibition on an adviser charging clients regulatory and compliance costs. Rather, it is that the construction of the rule itself will require advisers to make innumerable, immensely difficult judgments as to the types of expenses that constitute "regulatory or compliance fees or expenses of the adviser or its

[50] Private Fund Advisers Release, at 141.
[51] Private Fund Advisers Release, at 339 (Private Fund Proposal §275.211(h)(2)-1(a)(3) (emphasis removed)).
[52] Private Fund Advisers Release, at 141–42.

related persons."[53] The Private Fund Proposal acknowledges that "advisers often charge private funds for regulatory, compliance, and other similar fees and expenses *directly related to the activities of the private fund*" and asserts that "the proposed rule [does] not change this" – although the rule itself makes no such exceptions or distinctions.[54]

The absence of detailed discussion on this point in the Release suggests, perhaps, that the Commission itself may struggle with drawing the line between an "adviser" and a "private fund" expense. For example, the Release cites "costs associated with a regulatory filing of the fund, such as Form D" as an example of a type of expense that would not be prohibited.[55] But another readily available example—the filing of Form PF—is not discussed. When Form PF was first adopted, many private fund advisers in fact questioned whether costs associated with the filing of Form PF could be allocated to their private fund clients. Through examinations and informal staff statements, it became apparent to the industry that the staff viewed Form PF-related expenses as chargeable to a fund only if it was supported by relatively explicit disclosure or contractual provisions, and many private fund agreements now explicitly contemplate Form PF as a fund expense. Yet the rule would call the legality of such a provision or practice, even if fully agreed by and disclosed to investors, into question.

The Release states that, in ambiguous circumstances, the adviser should allocate fees and expenses "in a manner that it believes in good faith is fair and equitable and consistent with its fiduciary duty."[56] The Committees note that the general practice in the market is already for investment advisers to bear most regulatory or compliance fees and expenses, unless such fees or expenses are directly attributable to a specific fund client and that, even in cases where investment advisers charge their fund clients these sorts of fees and expenses, many advisers favor internalizing the costs rather than allocating them to the fund. Furthermore, the Committees note that the Private Fund Proposal would affect all investment advisers and not only the limited number of private fund advisers that charge certain of these Prohibited Expense Activities to their fund clients (and their underlying investors).

Thus, the Committees note that the effect of the Private Fund Proposal's rules on Prohibited Expense Activities could be to prohibit all private funds from bearing certain types of expenses that sophisticated investors have, in many cases, contractually agreed the fund may bear, while forcing the adviser to incur such costs, or costs that *potentially* may be encompassed by the prohibition, for itself. The likely outcome will be that advisers increase their management fees to provide additional "cushion" for such costs, without any clearly commensurate benefit to the fund or its investors. This would likely lead to a further, incongruous outcome: if the Commission's proposed requirements pertaining to periodic disclosure of fund and portfolio investment fees and expenses were adopted, investors in a fund with a "pass-through expense model" could theoretically have borne a lesser expense burden, and would have been able to monitor the underlying fees and expenses associated with that burden, but instead would bear a *higher* expense burden (through increased management fees) without knowing whether those fees are used to pay additional adviser expenses or instead simply contribute to the adviser's profit margin.

[53] Private Fund Advisers Release, at 339 (Private Fund Proposal §275.211(h)(2)-1(a)(3) (emphasis removed)).
[54] Private Fund Advisers Release, at 142 (emphasis added).
[55] Private Fund Advisers Release, at 142.
[56] Private Fund Advisers Release, at 142.

In addition, the broad wording and expansive definitions used in the Private Fund Proposals are likely to capture expenses and arrangements that may not have been the focus of the Commission's concern. In fact, the definition of "related person" is so broad as to create a circular conflict: because a private fund adviser typically will be deemed to "control" the private funds it manages, the private funds themselves are "related persons" of the adviser. At a minimum, the Committees note that this should be clarified in the final rule, as the intent of the prohibition does not appear to be that an adviser cannot allocate *any* regulatory and compliance costs to a private fund, even those relating to the operation of the fund itself.

This is not, however, the only example of situations where the Committees believe the breadth of the prohibition is excessive. The Committees believe that there are situations where it is reasonable for an investment adviser to pass these fees and expenses through to private funds. For example, if an anchor investor participates in "start-up" negotiations with an investment adviser or takes an interest in an investment adviser as a result of a "seed" deal, it can be appropriate for such anchor investor to bear, directly or indirectly, a portion of the adviser's registration- and compliance-related expenses. The Committees note that these arrangements with anchor or seed investors are not uncommon in the market. Because, however, the rule would, by its terms, prohibit an "investment adviser… indirectly… with respect to … any investor in a private fund" from "charg[ing] the private fund for any regulatory or compliance fees or expenses," even such arrangements between sophisticated counterparties negotiating in light of specific circumstances could potentially be proscribed.[57]

As a result of impacting the historical method of operation of the market as a whole, as well as those specific commercial arrangements that have been reached where such fees and expenses are paid, the Committees believe that the primary impact of the proposed Private Fund Proposal's bright-line restriction of these Prohibited Expense Activities blanket could be to frustrate the commercial goals and fact-specific negotiated commercial arrangements that have been reached by sophisticated counterparties, rather than serving to protect the interests of investors. Additionally, the Committees note that the blanket ban on Prohibited Expense Activities could result in adverse impacts to certain investment advisers that are a result of their structure and investment program rather than any potential incentive to place "their interests ahead of their clients' (and by extension their investors')."[58] For example, the Prohibited Expense Activities restrictions on these activities could have an adverse impact on new managers or managers focused on emerging markets who may have higher registration and regulatory compliance obligations and burdens, if such expenses cannot be specially allocated to sophisticated anchor investors as part of negotiations surrounding start-up costs and fund economics more generally.

Setting aside questions as to the Commission's statutory authority, the Committees respectfully suggest that, rather than instituting a blanket ban, the Commission could delineate a "safe harbor list" of specific compliance expenses that investment advisers to private funds are able to charge such funds. The Committees' view is that such permissible expenses should be listed on a non-exclusive basis in order to increase flexibility with respect to specific circumstances where passing through these sorts of fees and expenses may be reasonable, while increasing certainty in the market and protecting existing commercial arrangements and market practice.

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[57] Private Fund Advisers Release, at 339 (Private Fund Proposal §275.211(h)(2)-1(a)(3)).
[58] Private Fund Advisers Release, at 132.

b) Cost of Examination/Investigations

The Private Fund Proposal's rules on Prohibited Expense Activities would also prohibit investment advisers to private funds from charging such fund any fees or expenses related to an examination or investigation of the adviser (or its related persons) by a governmental regulatory authority. The Prohibited Expense Activities rules would not be limited to investigations by the Commission of registered investment advisers, but rather, apply to *any* government or regulatory authority.

As with the prohibition on private funds bearing regulatory and compliance costs of the adviser and its related persons, the Committees believe that the proposed prohibition on allocating examination or investigation costs of the adviser and its related persons to a private fund is excessively broad. The general practice in the market is for private fund governing documents not to treat the costs of ordinary course regulatory examinations or investigations pertaining to potential adviser misconduct as a fund expense. However, it is not unusual for investigations to arise in the course of a private fund's investment activity, which can easily extend to the adviser. For example, a contentious transaction involving a highly regulated industry could trigger a regulator's interest in the parties involved, which could easily involve a private fund adviser rather than just the funds it manages. The costs of an investigation by that regulator may have nothing to do with any allegation of adviser misconduct; in such circumstances, the expenses borne by the adviser may be more akin to deal-related costs. The proposed prohibition, however, would make no such distinction.

The Committees further note that, in some circumstances, fees and expenses related to regulatory investigations may be covered by the indemnity provisions of a fund's governing documents, in which case such fund (and, indirectly, its investors) would be required to bear such costs and expenses relating to such examination or investigation. In the majority of situations where an advancement of expenses for indemnification and exculpation is permitted, such fees and expenses are subject to recall or clawback in the event that an indemnified party is found to have breached the relevant standard of care under such fund's governing documents. The arrangements reached in the public company context function similarly in order to protect smaller retail investors. The Committees note that public companies generally allocate expenses related to regulatory investigations and examinations to such public company, which is subject to clawback upon a finding of wrongdoing by the company or its related persons.

In the Committees' view, the allocation of these sorts of fees and expenses via an indemnification provision already serves to protect the interest of investors as a finding of wrongdoing or breach of the relevant standard of care by an indemnified person serves to shift the costs back to the investment adviser. Although there may exist some potential uncertainty in determining a clear threshold for what would constitute a clawback event, in the context of advancing indemnification expenses to indemnified persons this definition is generally highly negotiated and more simple given the limited number of indemnified persons and payments. As a result of these established market mechanics, the Committees believe that the interests of investors, private funds and their investment advisers are generally aligned and do not require the sort of blanket prohibitions the Commission is proposing to address the risk that investment advisers may place "their interests ahead of their clients' (and by extension their investors')."[59] In addition, there exists the risk that the overly broad Prohibited Expense Activities blanket ban could capture inquiries or investigations that are more appropriately paid by a portfolio investment or a private fund if an investment adviser or its personnel become involved. For example, the Committees would expect that a private fund and its investors would be the appropriate parties to bear any fees or expenses arising as a result of an investigation by state-level regulators into "blue sky" filings, which would not touch on the management's company advisory business. Similarly, the Committees believe that a private fund or its portfolio companies are the proper payors of fees and expenses arising from state-level regulators' examinations or investigations of securities offerings by a portfolio investment, or certain investigations or examinations focusing solely on the business of a portfolio investment, which in each case would be far removed from the management company's advisory business.

3. Reducing Adviser Clawbacks for Taxes

The Proposal seeks to prevent advisers from taking into account actual, potential or hypothetical tax liabilities in determining the amount of any required adviser clawback. As described in more detail below, the Proposal is based on certain inaccurate assumptions regarding both the application of the U.S. tax rules to advisers and private equity funds, and the market formulation used by most (if not all) advisers to take into account taxes in determining the amount of a clawback.

In the first instance, the Committees note that while it has been the practice of the private equity industry for decades to offer clawbacks (and for taxes to be taken into account in determining the amount of a clawback), there is nothing that requires advisers to offer a clawback (and, indeed, other similar industries, such as hedge funds, generally do not provide for clawbacks, whether as a matter of market practice or because other mechanisms have developed to manage the issue that clawbacks are intended to address).[60] Advisers and investors are generally (and should continue to be) free to negotiate the economic terms of their arrangements. Investors negotiate substantial protections in the economic provisions of their private equity investments as part of an overall package, often including an after-tax clawback. Private equity investors have agreed to these provisions because they recognize that the adviser's employees who earn carried interest cannot be asked to go out of pocket for cash that has been paid to the U.S. Internal Revenue Service (the "**IRS**") (or other taxing authority).

The Commission's formulation of an after-tax clawback is inconsistent with how most private equity funds in the market actually structure clawback provisions. Under the market standard approach, the clawback is capped at the after-tax amount of the entire carried interest distributed to the adviser rather than reducing the clawback by taxes on the excess carry. As described below, because excess carry, if any, typically only represents a portion of the total carry received, clawback amounts typically are not reduced by taxes. A comparison of the Commission's formulation with the more standard approach highlights that removing the after-tax

[59] Private Fund Advisers Release, at 132.

[60] Hedge funds provide for an annual incentive allocation based on the increase to the hedge fund's NAV. Losses create a high watermark, such that typically no further incentive is paid by an investor until subsequent increases to the NAV reverse the prior loss.

cap in these circumstances would significantly harm advisers receiving carried interest because of how the U.S. tax rules apply to partnerships like private equity funds.

The Commission's example describes an adviser that receives excess carry of $10. The adviser's clawback obligation is reduced from $10 to $7 to take into account $3 of tax on the $10 of excess carry, such that only the after-tax excess amount is ultimately returned by the adviser. Under this formulation, a clawback would never restore the adviser and investors to their agreed upon economic sharing (*e.g.,* to an 80%/20% split). This is not how standard adviser clawbacks are structured. Standard adviser clawbacks require the adviser to return the *lesser* of (i) the amount of excess carry and (ii) the amount of total carry received by the adviser, *minus* taxes thereon. If, in the Commission's example, the adviser had received total carry of $20, with $10 representing excess carry, under the standard approach the clawback amount returned by the adviser would be the total excess of $10. This is because the after-tax clawback cap would be $14 (that is, $20 of total carry less $6 of taxes thereon, assuming the same 30% tax rate the Commission uses in its example), which is greater than the total excess amount of $10. Applying the standard after-tax cap therefore limits a clawback obligation only if the excess amount of carried interest represents more than the aggregate carry that was distributed and not paid in taxes. If the tax rate is 30%, the after-tax cap would apply only in circumstances where the excess carried interest received by the adviser is more than 70% of the total carried interest received.

In a circumstance where excess carry is in fact so significant as to include amounts that were paid in taxes, the members of the adviser that received the excess carry would be significantly harmed if taxes were not taken into account in determining the cap on the clawback amount, as this would require the individuals to come out of pocket twice for the same amount (once to the IRS or other tax authority and once to the investors). Moreover, even if carry proceeds were retained or escrowed by the adviser to fund a potential future clawback obligation and not distributed, under the U.S. tax partnership rules, the adviser must still allocate taxable income attributable with those proceeds to its members entitled to carried interest, resulting in a required tax payment by the individual members to the IRS (or other taxing authority). While in theory any prior income allocated to an adviser should be offset by losses in a later year in a clawback scenario, as described above, the tax rules on the utilization of losses are complicated and such losses often cannot be used. Contrary to the Commission's suggestion, the members of the adviser generally will not be able to avoid the tax rule limitations on loss utilization by amending prior tax returns.

The Commission asked for certain specified comments in the Proposal, including whether prohibiting taxes from being taken into account in a clawback determination may lead advisers to instead offer European style waterfalls to investors, where all capital is returned to investors prior to the adviser receiving any carried interest, and the risk of clawback is therefore reduced. Although all capital back waterfalls are less likely to result in adviser clawbacks, this is only true because of the tax cap on the clawback.

Under the U.S. tax rules governing partnerships, the taxes on carried interest do not always align with distributions of carried interest. For example, assume that a private equity fund with a 20% carried interest makes two investments each for $100 (total invested capital of $200). If the first investment is then sold for $200 (generating $100 of profit), and the fund has an American style/deal-by-deal waterfall, $20 of carried interest is distributed to the adviser and the adviser will pay tax on that amount ($6 of tax assuming a 30% tax rate). If, instead, the fund has a European style/return all capital waterfall, all $200 of proceeds must be distributed to the investors under the waterfall. However, and under U.S. tax rules, it is generally accepted that 20% of that income, or $20, will be allocated to the adviser in respect of carried interest, and the adviser's members will still be required to pay $6 of tax (assuming a 30% rate). As a result of the application of these rules, most U.S.-sponsored private equity funds with European style waterfalls will make tax distributions to the adviser during the term of the fund in order to pay these taxes. Under the Proposed Rule, however, the adviser would be required to return those tax distributions under the clawback if future losses outweighed these initial gains.

If the fund incurs subsequent losses such that the adviser is not ultimately entitled to any carried interest, the adviser will not always be able to obtain a refund of these taxes due to the U.S. tax rules governing the use of losses. This is the case regardless of whether the fund has an American or European style waterfall. In the example above, if the fund's second investment were sold for $0 in a subsequent year, then the adviser would be allocated a $20 loss to reverse the $20 of income previously allocated from the first investment. However, because individuals cannot carry back capital losses to prior years, the individual members of the adviser would not be able to amend their prior returns and claim a refund of the $6 of taxes already paid. Moreover, it is possible under U.S. tax rules that the $20 loss will never result in a tax benefit to the adviser due to the limitations on the use of capital losses.

Private equity investors and advisers have agreed to after-tax clawbacks recognizing that, as illustrated above, the adviser may be subject to taxes on carried interest in any particular year during a fund's term even if the advisor is ultimately subject to a clawback at the end of the fund's term. While some private equity investors do negotiate for tax benefits from the payment of the clawback to be taken into account in the after-tax calculation, these investors also recognize that taxes and tax benefits need to be determined based on hypothetical assumptions set by the advisers and disclosed to the investors.

The Proposal also asserts (and requests related comments) that the Commission has considered whether to allow for taxes to be taken into account in determining the amount of any clawback, but requiring the taxes taken into account to be actual tax liabilities rather than hypothetical tax liabilities. The Commission concluded that allowing for actual tax liabilities would be too burdensome for advisers. The Committees agree that using actual tax liabilities to determine an after-tax clawback will be impractical, as this would require an adviser to go through a burdensome exercise and create significant questions around how investors would properly audit an adviser's calculations in this regard. However, the Commission's proposal to exclude taxes from the clawback determination altogether imposes even more significant economic burdens on advisers, as discussed above. At a minimum, advisers should be free to cap their clawback obligation based on their actual tax liabilities incurred on carried interest. If the Commission goes forward with the Proposal, the Committees respectfully recommend that advisers should be free to limit their clawback exposure to the actual after-tax carried interest received.

4. Limiting or Eliminating Liability for Adviser Misconduct

The Proposal seeks to prohibit investment advisers from seeking reimbursement, indemnification, exculpation from or creating any limitation on its liability to a private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund (the "**Liability Limitation Prohibition**").

The Committees have three principal concerns with the Liability Limitation Prohibition: first, the prohibition is drafted broadly and would fundamentally interfere with investors' and investment advisers' ability to negotiate and describe the scope of adviser duties. Second, the approach undermines both the basic tenets of Advisers Act guidance and the relationship between the Advisers Act and other bodies of law without concern for the gap left by the Commission's apparent abandonment of prior guidance and law. Finally, the Proposal will increase costs, limit investment choices and hamper the ability of long-term main street investors to meet their investment return targets.

a) Scope

The Liability Limitation Prohibition extends beyond the activity that the Commission wishes to prohibit: the Proposed Rule states that the prohibition is intended to address contractual provisions that are made in violation of the Act.[61] By this, the Committees understand that the Liability Limitation Prohibition should be an extension of the long-standing concern of the Commission with respect to "hedge clauses" purporting to limit or waive an investor's non-waivable rights under federal or state law.[62] This concern is fundamentally driven by the idea that it is misleading to tell investors that they have waived rights that, in fact, cannot be waived.[63] But the Liability Limitation Prohibition goes further than this: it seeks to limit waivers of state-law duties that *can be waived.*[64] It facially applies to *any* claim arising out of fiduciary duty, gross negligence, malfeasance, bad faith, recklessness and negligence without any apparent consideration of whether these claims arise under federal securities laws or not. As described in greater detail in the next section, this dramatic expansion from the Commission's past "hedge clause" concerns will undermine how state law applies to funds and interfere with other bodies of law (such as ERISA's prudent person standard).

The plain language of the Liability Limitation Prohibition appears to prohibit limitations on liability based on breaches of fiduciary duty or (*inter alia*) negligence.[65] This drafting suggests that the prohibition extends to *any* negligent breach of an obligation (whether or not such obligation arises out of fiduciary duties). However, banning a limitation of liability for negligence would effectively create a strict liability standard of care for any action taken by an investment adviser on behalf of an investor. The Committees respectfully request confirmation of this point.

Even if the Liability Limitation Prohibition should be understood to apply only to fiduciary duties arising under the Advisers Act, there is no clear delineation between federal fiduciary duties and state law fiduciary duties. Although the 2019 Fiduciary Interpretation for the first time

[61] Private Fund Advisers Release, at 151 n.172.
[62] *See e.g.*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (July 12, 2019) (the "**2019 Fiduciary Interpretation**") at n.31.
[63] Private Fund Advisers Release, at 151 n.172; 2019 Fiduciary Interpretation at 10–11.
[64] See infra Section I.D.4.b of this letter for a Delaware law discussion on fiduciary waivers. This stands in direct contrast to the 2019 Fiduciary Interpretation, which in note 31 stated "This Final Interpretation does not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law."
[65] The rule would prohibit an adviser "directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for […] negligence."

collected various sources of Advisers Act fiduciary duty guidance in one document, it did not purport to create a comprehensive set of standards for fiduciary duty: rather it took a principles-based approach "allowing [advisers] flexibility to meet that standard in the context of their specific services".[66] But this flexibility then depends on investment advisory agreements being able to "shape" the adviser's duties.[67] Because the Liability Limitation Prohibition is so broadly drafted, it potentially leaves only the faint framework of a principles-based system without the substance in agreements to flesh it out. To compound matters, the Proposed Rule conflicts with the 2019 Fiduciary Interpretation in several respects,[68] and it is unclear whether the 2019 Fiduciary Interpretation continues to represent the views of the Commission and its staff.[69]

Finally, the Liability Limitation Prohibition is ambiguous: the Proposal bans "any limitation of liability", but all agreements where an adviser commits to perform certain services and not others is a limitation on liability. As noted above, the 2019 Fiduciary Interpretation depends on investment advisory agreement shaping the contours of the advisory relationship, but this "shaping" itself places limits on liability. The Commission and the Staff might believe that the line between "limitations of liability" for breaches of fiduciary duty and a legitimate description of services is clear-cut, but a few illustrations should show this is not the case. If a fiduciary has a duty of care and loyalty, then presumably its duty is to carry out its contractual duties in accordance with its contract: a breach of contract therefore becomes a breach of the duty of care unless defined otherwise by the contract. Similarly, any term that benefits the adviser at the expense of the fund is a breach of the duty of loyalty, but such terms include essential terms of service (like management fees and a description of how much time an adviser may spend on client matters). It is therefore essential that an advisory agreement be able to accurately and clearly describe the level of services that the adviser will provide. Investment advisory agreements typically employ a standard of care (*i.e.*, a gross negligence standard) to accomplish this, although an agreement could reach the same result by including an exhaustive list of what the adviser does and does not agree to. Perhaps this is what the Liability Limitation Prohibition is intended to accomplish. If so, the Committees do not believe it would result in clearer or better disclosure: it would lead to the same sort of long laundry-list disclosure that the Proposed Rule criticizes with respect to expense disclosures. The Committees therefore respectfully suggest that it is better to simply allow parties to say (as they do now) that they will perform their tasks in accordance with a gross negligence standard.

[66] 2019 Fiduciary Interpretation at 5.
[67] *See e.g.*, the 2019 Fiduciary Interpretation at 14 ("By contrast, in providing investment advice to institutional clients, the nature and extent of the reasonable inquiry into the client's objectives generally is shaped by the specific investment mandates from those clients.")
[68] For example, the 2019 Fiduciary Interpretation allows sophisticated parties to tailor investment advisory agreements to their circumstances, but the Proposed Liability Limitation would not allow this. The 2019 Fiduciary Interpretation appears to contemplate that appropriately drafted hedge clauses could be permissible in advisory agreements with sophisticated parties; the Proposed Liability Limitation appears to prohibit this.
[69] Not all members of the Committees agree, either, the 2019 Fiduciary Interpretation is a correct statement of law, and members concede that SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) should be read to create a federal fiduciary duty.

b) Contradictions to Existing Commission Guidance and Well-Established Law

The Liability Limitation Prohibition is not only ambiguous, but it also contracts past guidance and law. As noted above, the 2019 Fiduciary Interpretation expressly acknowledged that sophisticated parties could shape their relationships through their advisory agreements and took no position on the scope of fiduciary duty under state law.[70] The Liability Limitation Prohibition appears instead to limit waivers of fiduciary and other obligations under (for example) Delaware or Cayman Islands law.

The Limited Liability Prohibition purports to override the complex history of Delaware law that allows investors in Delaware entities to waive state-law fiduciary duties. It is clear under Delaware law that such duties exist.[71] However, fiduciary duties may be limited by an entity's organizational documents provided that they "may not eliminate the implied contractual covenant of good faith and fair dealing."[72] Any waiver of fiduciary duties must be explicit, and courts will strictly construe the terms of organization documents.[73] This represents a trade-off: because fiduciary duties may be eliminated, "it is essential that unitholders be able to hold the [fiduciary] accountable for not complying with the terms of the [organizational document]."[74]

As in the 2019 Fiduciary Interpretation, fiduciary duty under Delaware law consists both of a duty of care and a duty of loyalty. The duty of care requires (in the context of directors) the consideration of "all material information reasonably available to them".[75] While this standard would be difficult to comply with on a daily basis, Delaware law also shields directors with the business judgment rule: absent a conflict of interest or illegality, a court will presume that a director's business judgment was made "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[76] When coupled with the permissible waivers of fiduciary duty, Delaware entities effectively require a gross negligence standard before fiduciaries are held liable. Without a limitation on the state law duty of care, however, a manager would be (for example) required to use all material information reasonably available to it; but available information may be almost unlimited. The state law framework almost assumes that the duty of care will be modified. If advisers are prohibited from modifying the state law duty of care, there will be no restriction on the type of duty of care claims that can be brought against; almost any purported failure will state a claim.

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[70] See e.g., 2019 Fiduciary Interpretation at note 31 ("This Final Interpretation does not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law.")
[71] Boxer v. Husky Oil Co., 429 A.2d 995, 997 (Del. Ch. 1981) (general partners have fiduciary duties in limited partnerships); Feeley v. NHAOCG, LLC, 62 A.3d 649, 662 (Del. Ch. 2012) (managers and managing members have fiduciary duties in limited liability companies).
[72] Del. Code Title 6, Section 17-1101(d) (limited partnerships); Del. Code Title 6, Section 18-1101(d) (limited liability companies).
[73] See Auriga Capital Corp. v. Gatz Prop., LLC, 40 A.3d 839 (Del. Ch. 2012); Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160 (Del.2002).
[74] Brinckerhoff v. Enbridge Energy Co., Inc., C.A. No. 11314 (Del. Mar. 20, 2017).
[75] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
[76] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

A similar concern arises with respect to the duty of loyalty. Under Delaware law, the duty of loyalty requires that fiduciaries avoid "any conflict between duty and self-interest."[77] Unlike the duty of care, the duty of loyalty is not protected by the business judgment rule and breaches for the duty of loyalty can never be exculpated.[78] But in effect, this means it is essential that Delaware organizational documents must provide contours to the duty of loyalty. Advisory agreements may use phrases such as "the adviser will not be liable for the following conflicts […]", but this should be understood to be a way of describing the adviser's duty of loyalty rather than impermissibly waiving it. Because of the flat prohibition on exculpation for breaches of the duty of loyalty, Delaware law is not prepared for funds whose managers are unable to describe the bounds of their service.

As noted above, the Liability Limitation Prohibition does not just conflict with state law; it contradicts both recent and long-standing Commission positions. Through an established history, the Commission has previously established that hedge clauses, particularly as they are agreed upon by sophisticated parties, can be appropriate.[79] *Capital Gains* explicitly recognized a reasonableness standard: advisers must "employ reasonable care to avoid misleading clients" that would arguably be prohibited by the Proposed Rule.[80]

The Liability Limitation Prohibition may conflict with other bodies of law, as well. The Proposed Rule is premised in part on protecting pension plan investors,[81] but the Liability Limitation Prohibition is inconsistent with standards for pension plan investors. ERISA applies a prudent person standard to funds where ERISA plan participation is "significant".[82] The Proposed Rule, invoking concerns about pension plans, imposes a strict liability standard, even if plan participation is insignificant.

As noted previously and as described more thoroughly in Section III of this letter, the statutory authority of the Proposed Rule is itself a break from past practice. The Commission for the first time relies on Advisers Act Section 211(h) to promulgate the Proposed Rule. The Commission appears to ignore legislative intent and is applying the rule in a broader context. Specifically, Section 211(h) was added by Section 913(g) of Dodd-Frank to align fiduciary duties between broker-dealer and advisers with respect to retail investors. It was not intended to apply to private fund advisers.[83]

c) The Unintended Consequences for Investors and Investment Managers

The Committees are concerned not only by the ambiguity of the Liability Limitation Prohibition, and the break in guidance; instead, because the Liability Limitation Prohibition breaks with more than sixty years of Commission practice following *Capital Gains*, it increases legal and

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[77] Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987).
[78] See e.g., Del. Code Title 8, § 144(a) (2005).
[79] See SEC v. Capital Gains Research Bureau, Inc. 375 U.S. 180 (1963); the 2019 Fiduciary Interpretation.
[80] SEC v. Capital Gains Research Bureau, Inc. 375 U.S. 180 (1963).
[81] Private Fund Advisers Release, at 8.
[82] 29 U.S. Code § 1104(a); 29 CFR § 2510.3-101.
[83] See infra Section III of this letter.

regulatory uncertainty at both the federal and state level. It would affect nearly all advisory relationships with private funds at significant cost to the industry—and ultimately investors. While the Limited Liability Prohibition characterizes protecting managers from liability as purely self-interested, this protection is what allows managers to make good-faith decisions without fearing litigation down the line should the investment go awry.

Some investment strategies may not be viable if the Proposal shifts these costs to investment advisers. The Proposal will particularly increase costs for strategies that involve calculated risks and stifle innovation. For example, some strategies, by their nature, involve frequent trades and more opportunities for error (*e.g.*, quantitative investing and algorithmic trading, trading in markets where trade and settlement errors are more common or any strategy where there are higher chances for execution failures). Mistakes are also inherent in the development of novel strategies and taking risks. These errors may be due to mistakes in judgment or execution by the investment adviser, but they serve a purpose: they are inherent to these investment strategies and they are expressly part of the bargain between investment advisers, their clients and their investors.

The Liability Limitation Prohibition will favor well-capitalized, institutional investment advisers because it effectively requires advisers to insure execution risks of their private fund mandates. Talented portfolio managers will be less likely to start new investment managers. As with other portions of the Proposed Rule discussed throughout this letter, the Committees' concern is that only the largest managers survive, stifling competition and creativity in the industry. This may, in turn, reduce returns for investors.[84]

Some investors—particularly public employee benefit plans—need to take investment risks, and the Proposal risks undermining their ability to pay retirement benefits.[85] Retirement contributions from American workers have been paid over decades into a system that has assumed ambitious return targets. For these plans to have a chance to meet the return targets, they have determined that they must invest in alternative assets. In some states, this is a crisis, and states must either underpay retirees, or fund bailouts.

Against this backdrop, the Committees respectfully caution against the Commission proposing a dramatic change—in the name of such "main street" pension plans—to the deal that has been negotiated between investors and managers. If the Commission has doubts about the ability of such plans to evaluate private funds or disapproves of the ambitious return targets, then the logical next step is to enact reform of pension plans—that is the proximate cause of this problem rather than anything done by private fund managers.

Contrary to statements in the Proposed Rule, sophisticated investors (for instance, pension plans and large endowments) have used significant bargaining leverage to negotiate duties, indemnities and exculpation provisions. Managers and investors have actively negotiated these

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[84] *See e.g.*, Emerging Manager Out-Performance: Alpha Opportunities from the Industry's Newest Hedge Fund Managers available at
https://www.hedgeweek.com/sites/default/files/import_attachments/Emerging%20Manager%20Outperformance.pdf
[85] NASRA Issue Brief:
Public Pension Plan Investment Return Assumptions (Updated March 2022) available at
https://www.nasra.org/files/Issue%20Briefs/NASRAInvReturnAssumptBrief.pdf

provisions over many years. Even in so-called "funds of one", these standards are common. It is therefore particularly unfair to retroactively change a standard of care: the Liability Limitation Prohibition would effectively give some investors more than they bargained for.

d) A More Balanced Approach

Given these risks, it is worth asking why the Commission is regulating in this area. Investment advisers understand that Advisers Act duties are not waivable. The types of language cited in the Proposed Rule are ineffective. So the fundamental issue remains disclosure—and it should be remedied by disclosure. The Committees acknowledge that some hedge clauses are difficult to read, and that the Staff have long expressed concerns about misleading hedge clauses. But if investment advisers have failed to produce better disclosure, then the better route is to explain more particularly how existing disclosure is insufficient.

Fundamentally, the Committees believe that the disclosure-based, contract-based approach set-forth in *Capital Gains* appropriately balances investor protection with the need to take risks requested by investors. The Committees agree that indemnification and exculpation provisions should be comprehensible and proximate to discussions regarding the scope of services provided by investment advisers. The Committees further agree that investment advisers should be transparent about what their funds will invest in (scope/strategy), their idea generation process, their investment process, and their approach to risk management. However, in the Committees' view, the Commission should not include the Liability Limitation Prohibition. Instead, the Committees respectfully submit that the Commission should clearly articulate principles for appropriate disclosure of liability limitations and clarify that such disclosure principles apply only to non-waivable components of Advisers Act fiduciary duty.

5. Certain Non-Pro Rata Fee and Expense Allocations

The prohibited activities rule would prohibit an adviser from directly or indirectly charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the same adviser or its related persons have invested (or propose to invest) in the same portfolio investment. While the Committees agree that the Commission's goal to protect investors is of critical importance, the proposed outright prohibition on the so-called non-pro rata allocation of fees and expenses related to portfolio investments, which is ostensibly intended to eliminate conflicts of interest, is concerning for a number of reasons addressed below.

As a preliminary matter, this aspect of the Proposed Rule presupposes that the determination of what constitutes pro-rata will be obvious or self-evident in all cases. The instances where this is likely to be the case are far outweighed by the instances in which it will not. In the private fund context, the most obvious instance is two private funds managed by the same adviser, acquiring the same security at the same time and on the same terms. In this case, the basis for any pro-ration of an expense between these two funds is fairly obvious given the symmetry between to the funds with respect to their investments as noted above. However, what if these two funds are not in the same security, but in different parts of the company's capital structure? For instance, what if one of the funds is acquiring a control equity position, but the second fund is acquiring a debt instrument (perhaps alongside other third-party debt providers who do not typically pay the types of expenses incurred by an equity provider). In that case, what does "pro rata" mean from the perspective of the fund acquiring the debt (especially in an instance where the fund providing the equity would never have reasonably expected to share expenses associated with its equity investment, particularly if the debt providers had all been third parties). Similarly, what if one of the funds made its investment before the second fund and the investment by the second fund occurs on a follow-on basis. Will the second fund be required to reimburse the first fund for its "pro rata" share of expenses borne by the first fund? What if those expenses were borne years ago and the investment has since significantly changed in value? What if the only reason the second fund is investing is because the first fund is now out of capital? Why should the first fund expect any of its prior expenses to be shared in that instance and, even if it should, how should pro-rata be determined in that instance? Finally, what if the first fund conducted due diligence on the applicable company, but decided not to pursue the investment for legitimate reasons. For instance, a control buy-out fund might decide not to pursue an investment because it later determines that company management is unwilling to undergo any meaningful leadership or strategic changes. That investment might be unappealing to a control-buyout fund, but very appealing to a preferred equity fund where control is not a deciding factor. If a preferred equity fund of the same sponsor then pursues the investment, relying on the due diligence of the prior fund, should the latter fund reimburse the former fund for expenses that would have been "sunk costs" at that point? The Commission noted that fees and expenses attributable to unconsummated—or potential—portfolio investments should not be treated differently than consummated investments,[86] but the immediately noted example demonstrates that this principle will not always be simple or obvious to apply. If the investors of the control buyout fund were on notice (by way of robust disclosure) that such expenses might not be shared, one would have assumed that the sponsor had appropriately discharged its fiduciary duty, but this new outright prohibition would require otherwise.

Additionally, the Committees note that the ban on non-pro rata allocation of fees and expenses, when read in conjunction with the Private Fund Proposal's ban on the payment of fees and expenses attributable to unconsummated investments (or "broken deal" expenses), could impact co-invest pipelines. The current general practice in the market is for investment advisers to allocate "broken-deal" or other fees and expenses attributable to a proposed investment that a co-investor would have otherwise participated in to the "main" fund that such co-investor was investing alongside, so long as the practice is authorized by such fund's governing documents. The Committees believe that a blanket restriction on non-pro rata allocation would therefore serve to frustrate the commercial intent and negotiated arrangements of sophisticated counterparties, as well as the prevailing market practice in the co-investment context with respect to broken deal expenses. As a result, the Private Fund Proposal may ultimately result in fewer investment opportunities for investors participating via "main" funds, which are generally investors with smaller capital commitments and less negotiating power than co-investors. Furthermore, if the inability to allocate such fees and expenses on a pro rata basis prevents an investment adviser from pursuing an investment or otherwise results in a co-investor pipeline becoming exhausted due to lack of willingness to participate due to a change in market practice.

This leads to the Committees' second concern, which is that the conflicts that the Commission seeks to eliminate are already addressed by the fiduciary duty an investment adviser

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[86] Private Fund Advisers Release, at 154.

owes to its clients under the Advisers Act. As part of that fiduciary duty, an investment adviser must not subordinate its clients' interests to its own and must make full and fair disclosure to its clients of all material facts relating to the advisory relationship.[87] In particular, the Commission has stated that "an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[88] As part of their fiduciary duty, investment advisers are required to disclose their fee and expense arrangements to clients and this obligation, on its own, should be sufficient to address any conflicts of interest associated with fee and expense allocation. Investors in private funds are sophisticated parties who receive these disclosures and then negotiate the terms of their advisory relationship with private fund managers on "informed consent" basis. There may be circumstances where, due to tax, regulatory, or legitimate commercial reasons, it would be prudent for an investment adviser to allocate expenses on a non-pro rata basis (see above for several examples). In fact, requiring pro rata allocation in some cases could actually cause an investment adviser to violate its fiduciary duty to its clients. For example, where particular portfolio company fees and expenses are disproportionately related to the needs of a particular investor, an investment adviser could, in effect, be forcing other investors to subsidize the needs of that particular investor. In another example, a fund that would not be required to reimburse another might never have done so but for the affiliation between the two funds—a circumstance that comes up frequently between equity and debt providers as also noted above.

Moreover, as the Commission points out in the Release, investment advisers often have policies and procedures in place that permit the adviser to allocate fees and expenses in a fair and equitable manner (or similar standard), rather than on a pro rata basis.[89] Indeed, Rule 206(4)-7 under the Advisers Act requires that advisers adopt and implement written policies and procedures reasonably designed to prevent violation, by advisers and their supervised persons, of the Advisers Act and the rules thereunder. With respect to Rule 206(4)-7, the Commission has further stated that "[e]ach adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks."[90] This obligation further mitigates the conflicts of interest with which the Commission is concerned and begs the question why a so-called outright prohibition is necessary.

As such, the Committees believe that the existing regulatory framework, in which investment advisers owe a fiduciary duty to their clients and must implement policies and procedures under Rule 206(4)-7, already provides sufficient protection to address the Commission's concern and affords advisers with the flexibility to come to the "right answer" (if not the "better answer") on the question of how to allocate fees and expenses. As noted above, the Committees believe that flexibility is required because the determination of what constitutes pro-rata is impossible to reduce to a single rule. The Commission should therefore modify the Proposal to remove the prohibition on the allocation of fees and expenses related to portfolio investments and, instead, clarify that the Commission expects that the policies and procedures required under

[87] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019).
[88] *Id*.
[89] Private Fund Advisers Release, at 155.
[90] Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204 (Dec. 17, 2003).

Rule 206(4)-7 be reasonably designed to mitigate any conflict of interest posed by the allocation of fees and expenses related to portfolio investments.

6. Borrowing

a) Borrowings by an Adviser

The Committees respectfully submit that the final rule should not impose a prohibition on borrowings by an adviser or its related persons from a private fund.

Outside of the limited circumstances discussed below, in the Committees' experience it is uncommon for investment advisers to directly or indirectly borrow money, securities or other fund assets, or receive loans or extensions of credit (collectively, "**Borrowings**"), from a private fund client. However, when Borrowings do occur, they pose no greater conflicts of interest or risks than principal transactions regulated under Section 206(3) of the Advisers Act, which Congress chose to permit subject to informed consent from the client. Borrowings (as well as those activities referenced in footnotes 182 and 183 of the Release[91]) are already subject to general anti-fraud provisions of the Advisers Act as well as fiduciary considerations. As such, the Committees believe the proposed additional regulation of Borrowings outlined in the Release are unnecessary.

Similar to principal transactions, the Committees believe that providing full disclosure to, and receiving informed consent from, private fund clients is a more appropriate standard to apply to advisers engaging in Borrowings as it allows the parties to bargain for terms that are fair and beneficial to all sides with the benefit of the actual facts and circumstances prevailing at the time. Therefore, if the Commission chooses to specifically regulate Borrowings, the Committees recommend permitting them subject to: (i)clear disclosure in a fund's offering documents and limited partnership agreement regarding the possibility of Borrowings and, to the extent practicable, a general description of expected terms; (ii) the consent of the limited partners or limited partner advisory committee prior to each transaction (with the exceptions described below); and (iii) inclusion of amounts and terms of any Borrowings in annual reporting to investors.

b) A Private Fund's Tax Advances or Tax Distributions to the General Partner

The Committees respectfully submit that any rule prohibiting or conditioning Borrowings should exclude situations where a private fund makes tax advances or tax distributions to its adviser or affiliated general partner (or similar control person) (in this context, the "general partner"), to ensure that the general partner and its investment professionals are able to pay taxes derived from the general partner's interest in the fund.

Although not entirely clear from the Release, the Proposed Rule, if adopted, may limit tax distributions and advances (which the Commission appears to consider as loans for purposes of its Proposal) to a general partner. Based on the questions raised in the Release referencing tax distributions, the Committees believe it is important to address this point.

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[91] Private Fund Advisers Release, at 158 n.182–83.

Such amounts are typically paid to a general partner where the distribution waterfall requires distributions of cash to investors on a priority basis. As a result of priority investor distributions and "back-ended" general partner carry entitlements, a general partner will often recognize a tax liability in respect of carried interest that it has not received. Depending on the applicable facts and circumstances, such a tax liability could precede associated carried interest distributions by years. To protect the general partner from "phantom" tax liabilities (*i.e.*, a tax liability incurred without a cash distribution), most fund agreements provide for a tax distribution or advance to the general partner to pay such tax liability notwithstanding the investor distribution priority.

These payments are part of the standard terms and up-front partnership agreement drafting of a large majority of private funds, do not involve setting or negotiating terms with the fund after the partnership agreement has been executed (as is the case with a typical loan) and are well-understood by the investor community. Prohibiting these payments would impose a severe burden on general partners and their personnel by requiring them in certain circumstances to make tax payments (which can be substantial) before receiving the related distribution from the fund, which distribution may not occur, in many circumstances, for years after such tax payments. In addition, prohibition of such payments, while detrimental to all general partners, could be particularly problematic for newer managers who do not have sufficient assets or cash flow from prior funds to satisfy tax liabilities that may arise and in respect of which they otherwise receive no current distributions.

The Committees are not aware of any history of investor harm associated with these payments. Additionally, as the terms and mechanics of these payments are agreed to up-front by investors and sponsors in funds' limited partnership agreements, these payments do not present the conflicts of interest and potential for abuses discussed in the Release. Such payments are also not unique to private funds. Instead, tax distributions are common features of partnerships that include service and capital providers in many business arrangements outside of the private funds space (*e.g.*, operating companies).

c) Situations Where a Private Fund Is Making a Distribution to Its General Partner in the Form of a Loan

The Committees respectfully submit that any rule prohibiting or conditioning Borrowings should exclude situations where a private fund is otherwise making a distribution to its general partner (or similar control person) and such distribution recipient elects to receive such amounts in the form of a loan rather than a distribution.

While uncommon, such situations may occasionally arise due to, for example, jurisdictional requirements or non-U.S. tax efficiencies related to non-U.S. sponsors or individuals. These payments are typically structured such that investors are in at least as good a position as where the general partner (or similar control person) actually took a distribution in lieu of a loan. In addition, such loans do not present the conflicts and potential for abuse discussed in the Release because the terms and mechanics are agreed to up-front by investors and the sponsor in the fund's limited partnership agreement.

d) The Use of "Directly or Indirectly" for Financial Institutions Lending to Sponsors in the Ordinary Course

The Committees respectfully submit that the Release's use of "directly or indirectly" should be clarified to ensure that investors that are financial institutions (or affiliated with such institutions) are not prohibited from lending to sponsors in the ordinary course.

The Proposed Rule would prohibit Borrowings from a private fund client "directly or indirectly." This could be read to prohibit an adviser or related person from borrowing from an investor in a private fund client. As many banks, other financial institutions and their affiliates invest in private funds, the rule should be clarified to permit Borrowings from these investors and affiliates in the ordinary course. Such Borrowings do not implicate the policy concerns behind the Proposed Rule because these investors are sophisticated participants in the financial markets who are in the business of extending credit. Furthermore, given the vast size of some of these financial institutions, an adviser could inadvertently violate the rule by borrowing in the ordinary course from a distant affiliate of an investor in a private fund client.

e) Borrowings by a Private Fund Client from an Adviser

While generally not common in the Committees' experience except for the circumstances described below, Borrowings by a private fund client from an adviser or its related persons are beneficial to the fund and the investors, and therefore the Committees respectfully suggest that they should not be prohibited. Examples of such circumstances and benefits include sponsors (i) advancing certain fund organizational or operating expenses to third parties (*e.g.*, attorneys, corporate service vendors), which advances are repaid once the fund calls capital; (ii) "warehousing" an investment on behalf of the fund for a short time during the fund's organizational period and then transferring the investment to the fund once the fund is formed, sometimes charging a nominal interest rate (which is disclosed up-front and agreed to by all investors in the fund's limited partnership agreement); or (iii) being in the business (or having affiliated entities in the business) of lending capital and offering the fund more favorable terms than their competitors.

Conversely, prohibiting a private fund from borrowing from its sponsor may have unintended negative consequences for the fund (*e.g.*, prohibiting the sponsor from providing short-term "rescue capital" in the unlikely event such capital infusion is necessary).

As noted above, such activities are already subject to the general anti-fraud provisions of the Advisers Act and fiduciary considerations. Additionally, fund sponsors are typically permitted pursuant to the terms of the fund's limited partnership agreement to provide services to the fund or its investments, subject to the standards and protections negotiated in the fund's limited partnership agreement. The Committees believe lending should be treated no differently than the provision of other services, which raise similar potential conflicts of interest.

f) Form ADV

The Committees respectfully submit that it is not necessary to amend Form ADV to require advisers to report information about an adviser or its related persons lending to, or borrowing from, funds.

Given that an adviser's ability to borrow from or lend to a private fund would be disclosed in the fund's offering documents and limited partnership agreement, also requiring such information in Form ADV would be duplicative and not provide investors with any additional information or benefit. Instead, requiring such public disclosure could discourage borrowing activities as doing so may give the misleading impression that the adviser needed such loans due to financial weakness.

If the Commission wishes to collect data on such activities, the Committees believe inclusion in Form PF could be appropriate, although it would be important to distinguish between, for example, tax distributions (which are common) and true borrowings (which are less so).

E. Preferential Treatment

1. Prohibited Preferential Redemptions

As a general matter, the Committees agree with the notion that granting preferential liquidity to "favored" investors where such preferential liquidity rights are reasonably expected to have a material negative effect on other investors in the same fund should be at a minimum disclosed to all other investors. The Committees understand that by allowing those investors seeking liquidity ahead of others to redeem their interests, this could cause various negative effects on the remaining investors, including impairment to their ability to also redeem due to the imposition of "gates" and a negative impact on the value of the fund's portfolio due to the need to dispose of investments in order to raise sufficient capital to redeem the favoured investor's interests.

As proposed, however, a blanket prohibition on the granting of preferential redemption rights could actually run contrary to the stated policy objective of the Proposal, namely to not materially adversely affect other investors.[92] Investors in private funds often have specific legal, tax, regulatory, policy and other attributes requiring a more customized approach to their investments in private funds. Closed-end funds generally only provide for redemptions in very limited circumstances related to these attributes, and not as a commercial point to provide benefits to favored investors. As drafted, the Proposed Rule could limit the ability of certain types of investors to invest in private funds, as fund sponsors would not be permitted to accommodate the specific liquidity needs of these investors based on legal, tax, regulatory, policy and/or other considerations that are often of paramount importance to those investors (*e.g.*, an ERISA plan's need to withdraw in the event of an uncured "plan assets" problem) or an investor's particular investment policies or guidelines (which policies and guidelines are pervasive among U.S. public pension fund investors). Indeed, other investors may want investors with these particular liquidity or other issues to be redeemed out. Without the ability to be granted preferential liquidity rights, large institutional investors such as public and private pensions could have no other choice but to curtail their investment activity in private funds. Were these investors to cease to invest in private funds, this would necessarily deprive their underlying participants and beneficiaries of an important source of investment returns. Furthermore, it would leave the investors who do continue to invest in private funds in a worse position, as the retreat of large institutional investors from this investment sector would invariably lead to smaller fund sizes, which in turn would result in less

[92] Private Fund Advisers Release, at 163.

capital available for investments and more challenges to a fund sponsor's ability to execute on its investment strategy, fewer investors to bear expenses and more investment concentration—any of which could potentially be considered to have "material negative effects."

For hedge and other open-ended funds, while redemptions based on the "legal, regulatory, and tax considerations" are also a consideration, there are also exceptional redemption situations that are specific to open-ended funds. Redemption rights have evolved over the years to address legitimate investor needs in situations where the exposures in an open-ended fund's portfolio are ever-changing. These include (i) the need for investors to redeem from investment portfolios that would give an investor direct or indirect exposure to an entity in a regulated industry and where indirect exposure through a fund could cause an investor to exceed an exposure limit capped by law or regulation; (ii) similar exposure concerns for investors with exposure to commodity funds; and (iii) situations where an investor is required by its charter or policies to immediately divest from funds that invest in certain categories of investments (*e.g.*, Environmental, Social and Governance limitations) or asset classes. Given that these situations are all grounded in investor needs and/or regulatory compliance objectives, and are based on verifiable situations, the Committees respectfully urge the Commission to endorse a full and full disclosure policy over an effective prohibition that would, in the end, reduce opportunities for investors to achieve their management goals.

Finally, the Committees also note that there is also a well-established practice of "seeding" start-up private fund managers, where the seeding entities have redemption schedules that are outlined in advance and which may also provide redemptions in certain drawdown situations. These redemption rights are part of the bargain struck by investors in unproven, speculative startups and provide essential support for newer managers. These rights also tend to either expire or become immaterial after the initial launch period. The Committees respectfully urge the Commission to recognize the value to investors of these relationships and the broader benefit of bringing new managers to market, and to conclude that fulsome disclosure to subsequent investors of the effect of these potential withdrawals is sufficient protection.

Ultimately, without additional guidance, the standard of "material negative effect" creates ambiguities and arguably would cover any and all redemptions, whether for regulatory purposes or otherwise. The Committees respectfully urge the Commission to recognize the necessity as well as the value to investors of their bargained-for redemption rights and to conclude that, so long as there is adequate disclosure to other investors of the effect of these potential withdrawals, these kind of "preferential" rights are permissible.

2. Prohibited Preferential Transparency

As a general matter, the Committees agree with the Commission's view that where liquidity and redemption rights are a standard feature of a private investment fund (*i.e.*, open-ended funds), selective and preferential disclosures may provide certain investors with better information to evaluate whether to exercise liquidity rights, potentially having a material negative effect of other investors. However, selective disclosures and "front-running" are generally not relevant concerns in the closed-end fund context. As noted above, these funds have very limited liquidity rights—generally only in connection with specific legal, tax or regulatory reasons applicable to an investor. The receipt of additional information, in particular, information of the type that is of greatest concern raised in connection with this proposed rule, investment performance information and financial results, should not have any bearing on whether those types of legal, tax or regulatory reasons would be present. In addition, closed-end funds typically invest only in illiquid, private securities, and therefore front-running is impractical.

In addition, information asymmetry is an inherent structural feature of closed-end funds. At the time early close investors invest in a closed-end fund, they are generally underwriting a blind pool of assets. Closed-end funds will often continue accepting capital commitments for one year to eighteen months or more and those investors participating in later closings often have the benefit of seeing a partially constructed portfolio. This feature is accepted by both sponsors and investors.

Further, as discussed above, investors commonly require specific reporting tailored to their own legal, regulatory and tax considerations or an investor's investment policies or guidelines. The diverse nature of the investors in this industry often results in bespoke requests for information as investors focus on different metrics and data points, are subject to different reporting or regulatory regimes or simply have different formats that are better suited to their constituencies. Without the ability to request selective disclosures, many investors would find it difficult to comply with their investment policies and regulatory regimes. While providing all such information, to all investors would ensure that there was no preferential treatment, it would also be very impractical for investors to receive information that is not relevant to them and could lead to confusion.

Finally, for closed-end funds, confidentiality concerns (in particular regarding private investments), already naturally serve as limitations on disclosures of information on portfolio holdings. As a result, the market approach is well-established in satisfying the needs of both the advisers and investors. For open-ended funds, this is a solution in search of a problem. Market practice is to permit customized informational disclosures to selected investors *only* where there is legitimate need on the investor's side for such information (*e.g.*, to comply with internal reporting obligations) and where the adviser is comfortable that there is no material advantage being given to the investor by the customized disclosure. Given the fiduciary obligations under the Advisers Act and the overlapping Delaware and Cayman legal regimes that govern many funds, the latitude of an adviser to preferentially provide material information to an investor is, we believe, not an actual issue.

3. Substantially Similar Pools of Assets

The prohibitions on preferential liquidity and preferential disclosure contemplated in the Proposal are intended to address preferences granted to favored investors in a private fund sponsored by a private fund adviser that can have a material negative effect on other investors in such private fund or a "substantially similar pool of assets" managed by such fund adviser. The term "substantially similar pool of assets" is defined in the Proposal as "a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser or its related persons."[93] Except in the context of traditional fund-related vehicles that generally invest on a *pari passu* basis (*e.g.*, parallel funds, feeder funds, alternative investment vehicles), the Committees believe that the foregoing definition of "substantially similar pool of assets", which the Commission acknowledges is based on facts and circumstances, would in many cases make it difficult for fund sponsors and their advisers to determine their compliance obligations.

In response to pressure from investors and large allocators to accommodate particular investment objectives, policy requirements, risk tolerances, and other particularities, it is increasingly common for private fund sponsors to offer an array of investment options, including co-investment vehicles, "funds of one" and separately managed accounts. Although such vehicles and accounts can have investment programs that overlap with the investment programs of the private fund sponsor's flagship or other commingled funds, they also frequently feature material differences with respect to a wide variety of terms and conditions (*e.g.*, less investment discretion, more or limited leverage, limited or extra exposure to private investments, sector limitations, different target return profiles, and others). As a result, while it would be inappropriate to consider such other vehicles and accounts as "substantially similar", the broad scope and complexity of the variables that can come into play will necessarily cause sponsors to struggle drawing a "substantially similar" line.

The Committees believe that the regulatory uncertainty that would result from action by the Commission in this area would lead both to a material increase in compliance costs borne by fund sponsors and investors, and to a reduction in the number of sponsors willing to provide the desired level of customization to investors. The Committees therefore respectfully urge the Commission to narrow the definition of "substantially similar pool of assets" such that the prohibitions on preferential liquidity and preferential disclosure would apply only to fund-related vehicles that generally invest on a *pari passu* basis across all of the investments made by such vehicles.

4. Other Preferential Treatment

In addition to prohibitions on preferential liquidity and preferential disclosure, the Proposed Rule would prohibit other preferential terms being granted by private fund sponsors unless prospective and current investors are provided with a written description of such preferential terms. In the case of a prospective investor, the Proposed Rule would require a private fund sponsor to disclose preferential terms prior to the investor's investment. For an existing investor, a private fund sponsor would have to provide such description annually if any preferential treatment is provided to another investor since the last annual notice. Taking into account important differences between open-ended funds and closed-end funds, including with respect to subscriptions and redemptions, the Committees believe that compliance with the Proposed Rule would, in some cases, be impractical and, in other cases, have unintended consequences and/or limited utility.

With respect to prospective investors in a private fund, it is not always possible to disclose all preferential terms prior to the consummation of an investor's investment. In both open-ended funds and closed-end funds alike, private fund sponsors negotiate with numerous prospective

[93] Private Fund Advisers Release, at 335 (Private Fund Proposal §275.211(h)(1)-1 (emphasis removed)).

investors simultaneously. Given that a fund sponsor has no way of knowing which investors will consummate their proposed investment, there is no practical way for a fund sponsor to know which of the preferential terms being negotiated will ultimately be relevant and therefore require disclosure. In addition, compliance with the Proposed Rule during a closed-end fund's fundraising period could result in information asymmetry between investors who participate in a fund's initial close and investors who participate in a fund's subsequent closings. Investors who participate in the first closing of a fund would be in a position where they would not receive prior disclosure of any preferential treatment, but investors in subsequent closings would have the benefit of the disclosure before making their investment decision, creating an imbalance among these groups of investors. All other things being equal, the imbalance will create a "second-mover" advantage, dis-incentivizing investors from agreeing to subscribe for interests at point in time before such information is readily available.

Furthermore, compliance with the Proposed Rule will result in the disclosure of information that has limited utility for investors. For example, unlike with open-ended funds where liquidity is a standard feature, interests in closed-end funds generally may not be redeemed by investors and are subject to significant limitations on transferability. Given the substantial constraints on exiting an investment in a private fund, the benefit of ongoing disclosures is unclear. As another example, in some cases private fund sponsors agree to terms with investors that cover a broader relationship, which, for example, could relate to participation by investors in more than one fund product. This is an important feature for investors who seek the benefit of establishing broader relationships with some fund sponsors. It is unclear how investors in a particular product who are not similarly situated would benefit from enhanced disclosure as they could not, by definition, be able to receive the same terms. In both examples, we believe the additional compliance burden associated with the Proposed Rule is not justified by any perceived limited benefits that investors would receive.

Finally, investors in private funds routinely negotiate for a "most favored nation" ("**MFN**") provision that entitles them, following a fund's final closing, to review and elect the benefit of provisions they are eligible for under the terms of such provision. This MFN process results in disclosure of preferential terms to all investors at one time, a market-based approach that avoids information asymmetry and strikes a practical balance between the need for disclosure and the limited time and resources available to investors. Moreover, under the Proposal a fund would need to disclose a limited partner's side letter provisions before such limited partner participates in a given closing. In the case of limited partners that ultimately decide, for one reason or another, not to participate in a given closing, the fund will have disclosed side letter provisions that end up being irrelevant because they were not offered to any actual limited partner. By waiting until all of the limited partner investment decisions have been consummated, the traditional MFN process ensures that only provisions that are granted to actual limited partners will be disclosed to the other limited partners. Thus, this time-tested approach also has the benefit of eliminating the disclosure of proposed terms that ultimately are rendered irrelevant when prospective investors who were offered such terms do not consummate their investment, thereby reducing needless complexity and compliance costs. The Committees also believe that the Proposal would result in private fund sponsors having to conduct rolling MFN-like disclosure processes throughout a fund's fundraising period, which in turn would require investors to engage in multiple rounds of side letter review. Given the additional costs and burden for investors and sponsors alike, including additional compliance costs that would likely be passed along to investors as fund expenses, the Committees respectfully urge the Commission to defer to the long-standing industry approach to uniform, contemporaneous disclosure of preferential terms pursuant to "most favored nation" rights.

II. Annual Review

The Proposal would amend Rule 206(4)-7 under the Advisers Act to require an investment adviser to document (in writing) the annual review of the adequacy of the adviser's policies and procedures. While Advisers Act Rule 204-2 requires an investment adviser to maintain any records documenting its annual review that it may create, Rule 206(4)-7 does not explicitly require documentation. As a result, the Commission's Division of Examinations has observed over the years that some investment advisers were unable to provide evidence that an annual review ever occurred. The Proposed Rule is intended to fill this perceived gap and "help the staff understand an adviser's compliance program, determine whether the adviser is complying with the rule, and identify potential weaknesses in the compliance program."[94] The Commission has not, however, prescribed specific elements that an adviser must include in the written documentation of the annual review. The staff of the Division of Examinations generally reviews annual review reports to determine whether investment advisers have reviewed significant areas of their businesses, identified or reviewed key risk areas, and considered compliance matters and any changes to their businesses or applicable law that occurred during the year, including to identify deficiencies that might support claims that advisers failed to implement policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder.

The Committees suggest that this amendment is unnecessary and again burdens the private fund adviser with paperwork and cost, where the private fund adviser should instead be focused on achieving returns for its clients. Most private fund advisers, who follow best practices, are already documenting their review in writing. Making this process a written requirement will burden the Commission's limited resources in enforcing and examining a practice that is already widely adopted. Further, it provides areas where otherwise compliant advisers could be caught out of compliance for a non-material discrepancy with the Proposed Rule. The amendment will overly burden smaller advisers who will now have to devote resources to yet another written compliance task.

Further, it is generally not necessary to document in writing a full review and is an unnecessary expenditure of time and resources. In the alternative, if the Commission believes that there should be written documentation of some sort, then the Committees respectfully suggest that documenting specific material problems should be sufficient.

III. The Commission's Authority

The Release cites Sections 203(d), 206(4), 211(a) and 211(h) of the Advisers Act as the sources of the Commission's authority to issue the Proposed Rules.[95] However, the expansiveness of the Proposed Rules, and the breadth of activities of private fund advisers that such rules would seek to prohibit, restrict or require, in the Committees' view raises serious questions as to whether these statutory provisions can support the weight that has been placed upon them.

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[94] Private Fund Advisers Release, at 179.
[95] Private Fund Advisers Release, at 311.

Section 206(4) has two components. First, it prohibits an investment adviser, by use of interstate commerce, from directly or indirectly engaging in "any act, practice, or course of business which is fraudulent, deceptive, or manipulative."[96] Second, it authorizes the Commission to, "by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[97] In reviewing rules that the Commission has previously adopted under Section 206(4), a distinction can be drawn between (a) on the one hand, those rules which proscribe activities that the Commission has defined as *inherently* fraudulent, deceptive or manipulative,[98] and (b) on the other hand, rules that are *reasonably designed to prevent* acts, practices or courses of business that are fraudulent, deceptive or manipulative.[99] In both cases, however, the Commission's authority under Section 206(4) is constrained: the Commission may only adopt rules that prohibit, or are reasonably designed to prevent, activities that are "fraudulent, deceptive or manipulative" in nature.

Given what is, in the Committees' view, an attenuated relationship between many of the Proposed Rules and the prevention of fraud (which are addressed in greater detail above), it is unsurprising that the Commission also seeks authority for the Proposed Rules by citing to Sections 211(a) and (h) of the Advisers Act.[100] In particular, the Release partially quotes Section 211(h), stating that the section, added by the Dodd-Frank Act, "directs the Commission to 'facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with . . . investment advisers' and 'promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for […] investment advisers.'"[101]

Excerpting the language of Section 211(h) in this manner seems to suggest that Congress granted *carte blanche* for the Commission to mandate *any* disclosures to investors, and prohibit or restrict *any* sales practice, conflicts of interest, or compensation scheme relating to investment advisers, including advisers to private funds. The Committees submit, however, that this interpretation is complicated significantly when the language Section 211(h) is viewed in its entirety.

The full text of Section 211(h) is as follows:[102]

> *(h) Other matters*
>
> *The Commission shall—*
>
> *(1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships* ***with brokers, dealers, and*** *investment advisers,* ***including any material conflicts of interest****; and*

[96] 15 U.S.C. § 80b–6(4).
[97] 15 U.S.C. § 80b–6(4).
[98] For example, Rule 206(4)-2 (custody of funds or securities of clients by investment advisers); Rule 206(4)-6 (proxy voting); Rule 206(4)-7 (compliance procedures and practices); and Rule 206(4)-8 (pooled investment vehicles).
[99] For example, Rule 206(4)-1 (investment adviser marketing) and Rule 206(4)-5 (political contributions by certain investment advisers).
[100] Private Fund Advisers Release, at 311.
[101] Private Fund Advisers Release, at 7.
[102] 124 Stat. 1376

(2) ***examine and, where appropriate****, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for* ***brokers, dealers, and*** *investment advisers* ***that the Commission deems contrary to the public interest and the protection of investors****.*

The Committees believe that the references to "brokers" and "dealers" in Section 211(h) are critically important to its meaning, and that the Congressional intent behind Section 211(h) cannot be understood unless the provision is considered in the full context of the Dodd-Frank Act—in particular, Section 913 thereof—and the other amendments to the Advisers Act and the Securities Exchange Act that, through Section 913, were adopted concurrently with the addition of Section 211(h).

Section 211(h) was added to the Advisers Act by Section 913(g)(2) of the Dodd-Frank Act. Section 913 as a whole, however, deals with a much broader, and yet also more specific, subject matter, as its caption—"Study and Rulemaking Regarding Obligations of Brokers, Dealers, and Investment Advisers" indicates. Among other things, Section 913:

- mandated that the Commission conduct a study (the "**913 Study**") to evaluate, among many other things, the "the effectiveness of existing legal or regulatory standards of care for brokers, dealers, [and] investment advisers…for providing personalized investment advice and recommendations about securities to retail customers" and "whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, [and] investment advisers";
- required the Commission to seek public comment on, and submit to Congress, a report on its findings under the 913 Study;
- authorized the Commission, "as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide)," to commence rulemaking "to address the legal or regulatory standards of care for brokers, dealers, [and] investment advisers", taking into account the findings of the 913 Study;
- added Section 15(k) to the Exchange Act, which authorized the Commission to "promulgate rules to provide that, with respect to a broker or dealer, when providing personalized investment advice about securities to a retail customer (and such other customers as the Commission may by rule provide), the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under section 211" of the Advisers Act;
- added Section 211(g) to the Advisers Act, which authorized the Commission to

  "promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of this

Act when providing personalized investment advice about securities, except the Commission shall not ascribe a meaning to the term 'customer' that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser"; and

- added Section 211(h) to the Advisers Act—excerpted in whole above—and, critically, Section 15(l) to the Exchange Act, which is *word-for-word identical* to Section 211(h).

Taken as a whole, the Committees believe it is clear that the animating purpose behind Section 913 was not to create a new standard of conduct solely for investment advisers under the Advisers Act, but rather, to require the Commission to evaluate the differences between broker-dealers and investment advisers as relating to the services they provide—with the primary emphasis on *retail* investors—and to authorize rulemaking in furtherance of the Commission's findings.

It could be noted that Section 211(h) (and its implementing provision, Section 913(g)(2) of the Dodd-Frank Act) refers to "investors," while elsewhere Section 913 uses the word "retail customer" or simply "customer". This does not lead to the conclusion, however, that Congress intended to capture a broader universe of persons—notably, private fund investors—in Section 211(h) as contrasted to other provisions of Section 913. Indeed, Section 913(g)(2) specifically *prohibits* the Commission from defining "customer" to include "an investor in a private fund managed by an investment adviser" for purposes of establishing the standard of conduct applicable to an investment adviser to retail investors. Section 913(g)(2) also explicitly *permits* "retail customers" to consent to "material conflicts of interest" and *excludes* "the receipt of compensation based on commission or fees", "in and of itself", from being a "violation" of the standard of care applicable to a broker, dealer or investment adviser. It would be anomalous, to say the least, if the intent of Congress in using the word "investor" in Section 211(h) was both to scope in highly sophisticated investors in private funds *and* enable the Commission, through rulemaking, to prohibit or limit activities of advisers to private funds that Section 913(g)(2) expressly *permits* in respect of retail investors.

Nevertheless, the reasons why Congress might have chosen to use the word "investor" in Section 211(h) are not immediately apparent from the legislative history. The most plausible explanation derives from the structure and text of Section 913 itself. Section 211(g) of the Advisers Act and its parallel provision, Section 15(k) of the Exchange Act—both, as noted above, added by Section 913(g) of the Dodd-Frank Act—authorize the Commission to promulgate rules regarding the standard of conduct when an investment adviser or broker-dealer provides "personalized investment advice about securities to *a retail customer (and such other customers as the Commission may by rule provide*)".[103] If "investor" is understood as a means of referring to persons who receive individualized advice from an investment adviser or broker-dealer—whether such persons are retail or, instead, "non-retail" persons that the Commission has identified—then Section 211(h) and Section 15(l) can be read simply as an authorization for the Commission to engage in additional rulemaking in furtherance of its delineation of the standard of conduct for investment advisers and broker-dealers that provide individualized advice—that is, rulemaking to address "certain sales practices, conflicts of interest, and compensation schemes"

[103] 15 U.S.C. § 80b-11(g)(1) (emphasis added); 15 U.S.C. § 78o(k)(1) (emphasis added).

that, by their nature, are incompatible with such standard. By its nature, of course, the advice that a private fund adviser provides to a private fund generally is not "individualized" as such word is normally understood.

Indeed, if the intent of Congress in adopting Section 211(h) had been to grant authority for the Commission to regulate all manner of activities relating to private funds and their investment advisers, one would have expected to find such a mandate in Title IV of the Dodd-Frank Act, not in Title IX. Title IV amended the Advisers Act to require the registration of thousands of new private fund sponsors as investment advisers. Within Title IV, Section 404 established reporting requirements (ultimately implemented through the adoption of Form PF) relating to "trading and investment positions" "valuation policies and practices", "side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors" and "trading practices".[104] And, perhaps most significantly, Section 406 specifically *prohibited* the Commission from defining "client" for purposes of Sections 206(1) and (2) of the Advisers Act from including "an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser"[105] If Congress's intent had been to authorize the Commission to prohibit specific practices relating to private funds and their advisers, or to mandate certain disclosures by private fund advisers to investors (beyond such rules that prohibit or are reasonable to prevent fraud, deceit or manipulation under Section 206(4)), Title IV would have been the logical place to have done so.

Given what the Committees believe to be the absence of Congressional intent for Section 211(h) to serve as the basis for the Commission to regulate, in essence, *any* activity of private fund advisers, it is not surprising that many of the Proposed Rules do not squarely find support in the text of Section 211(h) itself, which refers to "sales practices, conflicts of interest *and* compensation schemes" (emphasis added). The Committees believe the better view of Section 211(h) is that Congress intended for these words to *collectively* serve as the foundation for Commission rulemaking—for example, rules that would support investors' understanding as to the differences between brokers, dealers, and investment advisers; the nature of the services that each such type of financial intermediary provides; the different compensation schemes that may apply to such intermediaries and their services; and, where the Commission finds "certain sales practices, conflicts of interest, and compensation schemes" to be "contrary to the public interest and the protection of investors", rules that may prohibit or restrict certain activities. In other words, the mere fact that, for example, a particular activity of a private fund adviser may entail a "conflict of interest" is not, by itself, sufficient under Section 211(h) to support its prohibition or restriction. Rather, Section 211(h) should not be invoked unless the activity in question involves not *only* a conflict of interest, but also a "sales practice" *and* "compensation scheme".

The Committees' concerns regarding the Commission's statutory authority are addressed further throughout this letter. As a general matter, however, the Committees urge the Commission, prior to adopting any final rule, to provide a more fulsome analysis of the basis on which each new Proposed Rule and requirement is supported by either Section 211(h) or Section 206(4) of the Advisers Act, including explicit consideration and discussion of both the Commission's understanding of the scope of its authority under these statutory provisions and the specific

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[104] 124 Stat. 1376.
[105] 124 Stat. 1376.

findings of the Commission relating to private fund advisers' activities that support the link between each proposed requirement or prohibition and its statutory foundation.

IV. Grandfathering

In amending certain rules in the past, the Commission has grandfathered investors with respect to their existing investments in order to avoid the costs and inconvenience associated with incorporating new rules into existing agreements. For example, in amending Rule 205-3 the Commission applied the proposed performance fee rules to new clients, but grandfathered existing arrangements with existing clients noting that "while we would require hedge fund advisers to comply with our performance fee rules going forward, we do not believe it is necessary to disrupt existing arrangements with persons who have already invested in the hedge fund."[106]

The Committees believe that freely negotiated economic terms between fund advisers and fund clients should not be disturbed by the Private Fund Proposal. The failure to include a "grandfathering" provision will likely lead to challenges for existing advisers who will be forced to choose between implementing the Private Fund Proposal and breaching previously negotiated agreements (such as side letter provisions). For example, the Private Fund Proposal prohibition against preferential redemption rights could impact conflicting side letters providing for limited redemption rights when an investor would otherwise exceed a specified ownership threshold with particular tax or regulatory ramifications.

In taking actions to modify an existing legal regulatory regime, the Commission is required by law to take into consideration the reliance interests of relevant stakeholders in such existing legal regime.[107] The Committees believe that investors and advisers who have negotiated arrangements that the Commission now proposes to prohibit, including contractual limitations on liability, have a vested reliance interest in the legality of the commercial arrangements they have negotiated and entered into. Additionally, the Committees note that existing arrangements between private fund advisers, private funds and investors have been negotiated, often at significant expense, on a holistic basis where all provisions, facts and circumstances are considered in coming to an agreement. In the Committees' view, the proposed piecemeal and involuntary revisions to existing arrangements between sophisticated investors and investment advisers risks upsetting the reliance interests of both parties in the existing regulatory regime. In sum, the Committees believe that the Private Fund Proposal will create uncertainty and volatility in financial markets by impacting existing agreements and would ultimately have an adverse effect on investors, advisers and their funds when they find themselves unable to engage in conduct in which they could previously engage.

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The Committees appreciate the opportunity to comment on the Private Fund Proposal. If we can be of any further assistance in this regard, please contact Michael Hong at the contact information provided below.

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[106] *See* Release No. IA-2333 (December 2, 2004)

[107] See Department of Homeland Security v. Regents of the University of California, 140 S. Ct. 1891, 1913 (2020); see also 5 U.S.C. § 706(2)(A).

Respectfully,

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Chair, Private Investment Funds Committee
[redacted]

John Fitzgerald
Chair, Investment Management Regulation Committee

cc: The Honorable Gary Gensler
The Honorable Caroline Crenshaw
The Honorable Allison Herren Lee
The Honorable Hester Peirce

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