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April 25, 2022

VIA EMAIL AT RULE-COMMENTS@SEC.GOV

Vanessa A. Countryman
Secretary, Securities and Exchange Commission
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Secretary Countryman:

Dechert[1] respectfully submits this comment to the Securities and Exchange Commission ("*SEC*" or "*Commission*") in connection with the Commission's request for comment on the proposed new rules and rule amendments (collectively, "*Proposed Rules*") that would significantly change the regulation of private funds and their advisers including by, among other proposed changes, requiring private fund audits, prohibiting certain activities and restricting certain types of differential treatment of investors.[2]

We appreciate the SEC's initiative in considering how to regulate private funds and their advisers in light of the beneficial role that private funds perform in the economy. However, we believe that the proposed regulations would reflect a major change in the SEC's approach to the regulation of private funds specifically and the interpretation of the Investment Advisers Act of 1940, as

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1 Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and worldwide. Our clients include, among others, a wide variety of registered and unregistered investment companies (including mutual funds, closed-end funds and business development companies), private funds, investment advisers, broker-dealers and institutional investors. An extensive part of our services for these clients involves assistance with the federal securities laws in the organization, distribution and operation of investment funds. The comments herein reflect our own views and not necessarily the views of our clients.

2 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Proposed Rule, SEC Rel. No. IA-5955, 87 Fed. Reg. 16886 (March. 24, 2022) ("*Proposing Release*").

amended ("*__Advisers Act__*"), more generally. Moreover, the added burdens of the Proposed Rules would increase costs for all private funds and their advisers and their investors, create new barriers to entry and disproportionately impact smaller or less-established managers. Notably, the Proposed Rules would impose a substantive regulatory framework for the first time on a set of industries that have thrived under the current, primarily disclosure-based regime, under which market forces and negotiation have protected investors while fostering innovation.

As recently as October 2020, the Commission stated that "[w]e [the Commission] believe that the individuals and institutions that will be newly eligible accredited investors under the final amendments have the requisite financial sophistication for meaningful investment analysis, and could therefore benefit from gaining broader access to investment opportunities in private capital markets and greater freedom to make investment decisions based on their own analysis and circumstances."[3] In contrast, the Proposed Rules would introduce substantive restrictions without meaningful exceptions, thereby reducing the ability of sophisticated private parties to negotiate the terms of their investments into private funds on their own terms and in their own interests, including with respect to such critical matters as the amount of risk that each party is willing to bear. This shift in regulatory approach would have impacts beyond the specific proposed restrictions. If implemented, major, industry-wide efforts to revise and renegotiate the terms of organizational and offering documents will be necessary, imposing significant costs on advisers, funds and investors. These renegotiations would have an adverse impact on the pricing and availability of private funds generally and have the potential for significant and disparate impacts on a number of types of investment strategies. The Proposed Rules would also impact non-U.S. advisers offering non-U.S. products, managers to accounts that are "substantially similar pools of assets" to private funds (*e.g.*, collateralized loan obligations), as well as advisers to investment companies registered under the Investment Company Act of 1940, as amended ("*__1940 Act__*").

While the scope of our comments is limited to particular aspects of the Proposed Rules, we appreciate the opportunity to submit these comments on the Proposed Rules.

3 Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status, 85 Fed. Reg. 64234 at 64267 (Oct. 9, 2020) ("*__Accredited Investor Adopting Release__*").

I. <u>Quarterly Statements</u>

A. <u>Quarterly Statements Need Not be Required, and if Required, Advisers and Private Fund Investors Should Retain Discretion to Tailor their Form and Content</u>

The SEC proposes to require advisers to prepare and deliver to investors quarterly statements concerning each private fund's fees, expenses and performance containing certain prescribed information and in a prescribed format. We believe that quarterly statements need not be required because they are already commonplace. Reporting is a point upon which the parties negotiate and should be tailored to the strategy and the underlying investments. If the Commission intends to impose this requirement, it should not dictate the form or content, and leave this to the parties.

B. <u>Unnecessary Application of the Quarterly Statement and Other Requirements to Regulated Funds</u>

Investment companies registered under the 1940 Act and companies that have elected to be regulated as business development companies under the 1940 Act (collectively, "*<u>Regulated Funds</u>*") may employ or invest in special purpose and other unregistered pooled investment vehicles for a number of reasons, including to: (1) implement their investment objectives and strategies; (2) address specific regulatory or tax limitations; and/or (3) facilitate certain investments and other transactions (including secured borrowing arrangements). These vehicles could, but will not always, meet the definition of a "private fund" under the Advisers Act. In many cases, these vehicles are wholly owned and controlled by, and their holdings are consolidated on the financial statements of, the acquiring Regulated Funds. Under these circumstances, this type of vehicle is merely the alter ego of an acquiring Regulated Fund and acts as a conduit for the Regulated Fund's investments. In the remaining cases, these vehicles (and their related fees and expenses) are disclosed in a Regulated Fund's registration statement and/or periodic reports delivered to shareholders and filed with the Commission under the federal securities laws, including the Securities Act of 1933, as amended ("*<u>Securities Act</u>*"), the Securities Exchange Act of 1934, as amended ("*<u>Exchange Act</u>*") and the 1940 Act. The Commission and its Staff are aware of and have accepted these arrangements because they are fully and fairly disclosed[4] in filings with the

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4 *See, e.g.*, Funds of Funds Arrangements, SEC Rel. Nos. 33–10871; IC–34045 (Oct. 7, 2020) ("[w]holly-owned subsidiaries are typically organized [by Regulated Funds] under the laws of a non-U.S. jurisdiction in order to invest in commodity-related instruments and certain other instruments for tax and other reasons. . . . Because the wholly-owned subsidiary's financial statements are consolidated with the financial statements of the acquired fund, we do not believe that this arrangement would be so complex that investors could not understand the nature of such exposure). *See also* South Asia Portfolio,

Commission and may operate under exemptive relief, or operate pursuant to an exemptive rule, under the 1940 Act.[5]

We are concerned that the Proposed Rules could unnecessarily disrupt these long-standing arrangements. For example, Proposed Rule 211(h)(1)-2 would require a registered investment adviser to prepare a quarterly statement "for any private fund that it advises, directly or indirectly," disclosing private fund fees, expenses and performance, and to distribute the statement to the private fund's investors. The Commission expects that the quarterly statement would "allow investors to understand and monitor their private fund investments better."[6] In the Proposing Release, the Commission stated that, if a private fund investor "is itself a *pooled [investment] vehicle* that is controlling, controlled by, or under common control with the [private fund] adviser or its related persons (a 'control relationship')," Proposed Rule 211(h)(1)-2 would require the adviser to "look through that pool" in order to distribute the quarterly statement to the investors in the pooled investment vehicle.[7] The Proposing Release suggests that the "look through" distribution requirement is intended, in part, to "preclude advisers from using layers of pooled investment vehicles in a control relationship with the adviser to avoid meaningful application of the distribution requirement." The Commission provides examples where it expects such a look-through requirement would be appropriate, including when using special purpose vehicles or master-feeder

SEC No-Action Letter (pub. avail. March 12, 1997) and Templeton Vietnam Opportunities Fund, Inc., SEC No-Action Letter (pub. avail. Sept. 10, 1996) (granting no-action assurances for wholly-owned subsidiary structures to access certain non-U.S. markets).

5 To the extent a registered investment company invests in a private fund that is a first- or second-tier "affiliated person," these arrangements are subject to the affiliated transaction prohibitions under Section 17 of the 1940 Act. Business development companies are subject to similar restrictions under Section 57 of the 1940 Act. However, the Commission has adopted exemptive rules and issued exemptive relief for certain arrangements where the statutory prohibitions are inappropriate or unnecessary for the protection of investors. *See, e.g.,* 1940 Act Rule 12d1-1 (exemption from Sections 17(a) and 57 of the 1940 Act and Rule 17d-1 thereunder for transactions with private money market funds that comply with Rule 2a-7 under the 1940 Act); Rule 17a-3 under the 1940 Act (exemption from Section 17(a) of the 1940 Act for transactions with "fully owned subsidiaries"); Principal Funds, Inc. et al., Investment Company Act Rel. Nos. 33843 (April 21, 2020) (notice) and 33886 (order) (May 20, 2020) (granting exemptive relief from Sections 17(a) and 17(d) of the 1940 Act and Rule 17d-1 thereunder to permit registered investment companies to invest in a private real estate fund).

6 *See* Proposing Release at 16890.

7 *See* Proposing Release at 16908 (emphasis added). For these purposes, a "pooled investment vehicle" is not defined. *See* Proposed Rule 211(h)(1)-1 (defining "distribute"). However, in defining "substantially similar pool of assets" under Proposed Rule 211(h)(1)-1, the Commission excluded pooled investment vehicles that are registered under the 1940 Act "or a company that elects to be regulated as such."

structures.[8] It is not clear to us whether the look-through requirement was intended to apply to Regulated Funds that invest in private funds.[9]

We acknowledge that the Commission believes that the look-through requirement may be helpful to investors that are not already required to receive detailed information about the fees, expenses and performance of their investment. However, we do not believe that the look-through requirement should apply to Regulated Funds that invest in private funds, for a number of reasons. First and foremost, Regulated Funds are already subject to the most robust and comprehensive disclosure and periodic reporting requirements under the federal securities laws, including the Securities Act, the Exchange Act and the 1940 Act. Under these requirements, Regulated Fund shareholders already receive comprehensive, standardized information[10] about their investments in Regulated Funds and related fees and expenses (including "acquired fund fees and expenses")[11]. Accordingly, Regulated Fund shareholders would not benefit, in any meaningful way, from additional information about any particular investment by a Regulated Fund in a private fund, particularly when the private fund's holdings are consolidated on the financial statements of the Regulated Fund.[12] Moreover, distributing private fund account statements to Regulated Fund shareholders would cause confusion, given the significant amount of fund-level reporting they already receive.

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8 *See* Proposing Release at 16908.

9 For purposes of this section, we have assumed that a Regulated Fund would have a control relationship with the private fund adviser or its related persons.

10 The SEC has acknowledged the sufficiency of the current disclosure regime in the Regulated Fund context: "[i]n the registered fund context, fund-level reporting has, in our view, enabled retail investors to understand their investments better." Proposing Release at 16891.

11 Regulated Funds are currently required to disclose the fees and expenses they incur indirectly from investing in shares of one or more other Regulated Funds or private funds. *See* Instruction 3(f)(i) to Item 3 of Form N-1A (registration form for registered open-end investment companies). Other forms, including Form N-2 (registration form for registered closed-end investment companies and business development companies) similarly require disclosure relating to "acquired fund fees and expenses."

12 Even if there was some remote benefit to the application of the look-through requirement to Regulated Funds that invest in private funds, the costs would clearly outweigh it. Although the Commission acknowledges that private fund advisers may deliver account statements through either paper or electronic means, the very broad and intermediated shareholder base of Regulated Funds would create tremendous costs and complexities that may disincentivize investment advisers to Regulated Funds from investing in private funds. And, if the private fund is wholly owned and controlled by a Regulated Fund, the Regulated Fund shareholders could potentially incur the costs of *preparing* and *distributing* quarterly account statements, from which the Regulated Fund's shareholders would receive no meaningful additional information.

A Regulated Fund's investment in a private fund is already overseen by an independent "watchdog" – the independent directors of the Regulated Fund.[13] The presence of independent directors substantially mitigates the risk that Regulated Fund shareholders are not receiving clear, detailed and standardized disclosure about their investments and related fees and expenses. Simply put, the policy objectives of Proposed Rule 211(h)(1)-2 – to increase transparency in the private fund market and allow investors "to assess and compare their private fund investments better"[14] – are not furthered by requiring a private fund adviser to distribute private fund account statements to Regulated Fund shareholders.

For the reasons discussed above, we believe that there should be an exemption in Proposed Rule 211(h)(1)-2, if adopted, for private funds that are formed and operated for one or more Regulated Funds in the same fund complex. We also believe the look-through distribution requirement, if adopted, should not apply to Regulated Funds that invest in private funds or, alternatively, that a private fund adviser should be able to satisfy its delivery requirements by delivering any required statements to a Regulated Fund's chief compliance officer, audit committee or independent directors. The Commission Staff has endorsed this "substituted" delivery requirement in the context of Rule 206(4)-2.[15]

In addition, we believe that the Commission should carefully consider how some of the remaining Proposed Rules could unnecessarily (and likely unintentionally) impact Regulated Funds in light of the existing protections of the 1940 Act and the policy objectives of this rulemaking, and should

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13 As the Commission Staff has acknowledged, "Congress intended to place independent directors in the role of 'independent watchdogs,' who would furnish an independent check upon the management of funds and provide a means for the representation of shareholder interests in fund affairs." Interpretive Matters Concerning Independent Directors of Investment Companies, SEC Statement of Staff Position, SEC Rel. No. IC-24083, 64 Fed. Reg. 59877 (Oct. 20, 1999) (citing *Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1979) and *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before the House Subcomm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 109 (1940) (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC)).

14 *See* Proposing Release at 16890.

15 *See* Staff Responses to Questions About the Custody Rule, Question VI.10 (March 5, 2010), *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm ("[t]he Division would not recommend enforcement action to the Commission under Rule 206(4)-2 if the audited financial statements of the unregistered money market funds are not delivered to the shareholders of the registered investment companies, provided that the financial statements are delivered to each registered investment company's chief compliance officer, audit committee members and the members of the board of directors who are not interested persons of the adviser").

adopt exemptions to minimize these unnecessary disruptions to Regulated Funds. For example, Proposed Rule 206(4)-10 could require a private fund that is wholly owned and controlled by, and whose holdings are consolidated on the financial statements of, an acquiring Regulated Fund, "to undergo a financial statement audit … at least annually and upon liquidation." Of course, the consolidated financial statements of the Regulated Fund (and its wholly owned subsidiaries) are already subject to an annual audit requirement, and these consolidated audited financial statements are already delivered to the Regulated Fund's shareholders.[16] Proposed Rule 206(4)-10 would appear to require an additional, special audit upon liquidation of the private fund (which may not coincide with the liquidation of the Regulated Fund) and the distribution of the financial statements associated with the liquidation audit to the Regulated Fund's shareholders. For reasons similar to those discussed above, we believe that this requirement imposes unnecessary costs without any benefit to the Regulated Fund's investors.

II. Private Fund Audits

The Commission proposes to require that each private fund advised by an investment adviser that is registered or required to be registered with the Commission undergo an audit annually and upon liquidation ("***Proposed Audit Requirement***").[17] In most cases, the financial statements would need to be prepared in accordance with U.S. Generally Accepted Accounting Principles ("***U.S. GAAP***").[18] The GAAP Audits would be required to be delivered promptly to fund all investors.[19] In the Proposing Release, the SEC indicates its belief that the Proposed Audit Requirement would "provid[e] protection for the fund and its investors against misappropriation of fund assets [and] an

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[16] *See* Investment Company Consolidation, IM Guidance Update No. 2014-11 (Oct. 2014), *available at* https://www.sec.gov/investment/im-guidance-2014-11.pdf.

[17] *See* Proposed Rule 206(4)-10.

[18] For private funds organized under non-U.S. law, or that have a general partner or other manager with a principal place of business outside of the U.S., financial statements must contain information substantially similar to statements prepared in accordance with U.S. GAAP, and material differences from U.S. GAAP must be reconciled. *See* Proposed Rule 206(4)-10(c). For ease of reference, this Comment Letter refers to financial statements and audits that would comply with the Proposed Rule as "***GAAP Audits***," respectively. Although we disagree that an audit requirement should be extended to all private funds, to the extent that the SEC determines to adopt such a requirement, Dechert (i) believes that the requirement should not apply to an offshore investment adviser with respect to its offshore funds; and (ii) agrees that the above-mentioned exception should be included.

[19] Where a fund investor is an affiliated pool, the SEC proposes to require delivery to that pool's investors. As discussed above, we do not believe that delivery should be required to investors in a Regulated Fund that invests in a private fund, and, where the private fund is consolidated with the Regulated Fund, we believe that a separate audit of the private fund should not be required.

important check on the adviser's valuation of private fund assets, which often serve[s] as the basis for the calculation of the adviser's fees."[20]

We are concerned that if the Proposed Audit Requirement is adopted in the form proposed, certain types of private fund structures, strategies or investments could become significantly more costly for investors and advisers (and, in some cases, could be impractical or impossible for advisers that are subject to the rule to offer through a private fund). This cost would not outweigh any benefits of the Proposed Audit Requirement since, in our view, a GAAP Audit and the distribution of GAAP Financials by private funds currently engaging in strategies where GAAP Audits have not traditionally been expected would offer minimal if any benefit to investors in private funds pursuing those investments or strategies. As a result, while we recognize that investors in many private funds do benefit from having the fund undergo an audit and receiving audited financial statements,[21] in light of existing requirements and practices,[22] we believe that it would not be advisable to require that (i) every private fund be audited or (ii) that all private fund financials should be subject to particular, prescribed requirements.[23] In fact, in many cases, the types of private fund investments, strategies and structures for which this Proposed Audit Requirement would be most burdensome are those for which the SEC's primary justification for the Proposed Audit Requirement (*i.e.*, preventing opportunistic valuation that would artificially inflate the adviser's fee) simply is not present.

As recognized by the SEC, "more than 90 percent of the total number of hedge funds and private equity funds that are advised by RIAs currently undergo a financial statement audit . . . and other types of funds advised by RIAs [other than securitized asset funds] undergo financial statement

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20 *See* Proposing Release at 16911.

21 As discussed below, most private funds (including the overwhelming majority of hedge and private equity funds), already are subject to audits. Additionally, we note that certain types of funds that are not traditionally subject to GAAP Audits, such as securitized asset funds (*e.g.*, CLOs), do not compensate their adviser based on market values.

22 The Custody Rule, for example, provides adequate protection against misappropriation while still allowing an alternative approach where a GAAP Audit is not feasible or desired. Similarly, the SEC's recently adopted amendments to Advisers Act Rule 206(4)-1 ("***Marketing Rule***") addressing adviser and private fund marketing should provide sufficient protection against opportunistic valuations being used to inflate performance claims, while Advisers Act Rule 206(4)-8 already addresses false or misleading statements to private fund investors or prospects. These rules, together with the SEC's enforcement authority and the general Advisers Act antifraud and fiduciary protections, obviate the need for the proposed blanket audit requirement.

23 As a general matter, SEC rules have allowed (and in many cases required) consideration of the relevant facts and circumstances rather than imposing one-size-fits-all solutions.

audits with similarly high frequency."[24] Not all private fund arrangements result in the adviser being subject to Advisers Act Rule 206(4)-2 ("*Custody Rule*"). Without the access to client funds and securities that results in custody, the Proposed Audit Requirement does not provide protection from residual misappropriation risk (if any) sufficient to justify the cost of an audit.[25] For the relatively rare circumstances where an adviser elects not to apply the audit approach, the Custody Rule already provides sufficient protections through the account statement delivery and independent verification requirements.[26] In our experience, advisers take the account statement/independent verification approach to custody when a GAAP Audit cannot practicably or timely be performed because the private fund holds one or more assets for which valuation cannot be readily determined in a manner that is consistent with U.S. GAAP. In these cases, it would be impossible for the private funds that hold such assets to comply with the Proposed Audit Requirement. Compounding this issue, it is not always possible for an adviser to know at the time such an asset is acquired that it will pose a U.S. GAAP valuation problem.[27] Current requirements

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24 *See* Proposing Release at 16941-42.

25 As discussed below, we do not believe that a separate audit requirement through the Proposed Audit Requirement is warranted to address misappropriation risk. Where an adviser is not deemed to have custody, there is little risk of misappropriation that would be ameliorated by applying the Proposed Audit Requirement. Where an adviser does have custody, the Custody Rule is the proper avenue for ameliorating this risk, and we are concerned that the Proposed Audit Requirement would effectively require all private funds to elect the audit method for Custody Rule compliance. As discussed below, some managers have found the account statement/independent verification approach necessary to address the issues discussed surrounding valuation, and others have determined to follow that approach when the audit approach is determined to be otherwise less efficient for the particular fund. Should the SEC determine to adopt the Proposed Audit Requirement (and given that the variations between the Proposed Audit Requirement and the Custody Rule are not meaningful in terms of the protections offered, we would recommend that the terms of such rule and those of the Custody Rule audit approach be harmonized for advisers that have custody and have elected to comply with the Custody Rule for a particular fund through the audit approach, such that compliance with either would result in compliance with both.

26 Potential amendments to the Custody Rule, which are included in the SEC's Regulatory Flexibility Agenda, would be the more appropriate avenue for addressing any concern that these requirements are not sufficient.

27 We note that this issue does not impact the utility of a financial statement audit in combatting misappropriation – the auditor still is in a position to verify the existence of an asset regardless of whether the asset is readily susceptible to U.S. GAAP compliant valuation.

under the Custody Rule, on the other hand, provide an alternative approach to protect investors that would not force an adviser to eschew such investments.[28]

While securitized asset funds (*e.g.*, CLOs) are not typically subject to a GAAP Audit, many are subject to reviews by independent auditing firms under agreed-upon procedures ("*AUPs*") that provide assurances that are relevant to the investors in light of the securitization structure. Advisers to CLOs typically receive a collateral management fee that is based on the CLO's principal balance and can benefit if excess returns are generated but do not benefit from increased valuations or unrealized gains. Additionally, CLOs are generally not marketed in a manner where the adviser would benefit from opportunistic valuation. As a result, the policy benefits cited by the SEC as inuring from the Proposed Audit Requirement do not appear to apply to securitized asset funds. The market agrees: the relative rarity of GAAP Audits in the CLO context, and the presence of AUPs, suggests that CLO investors, who are generally sophisticated institutions, do not believe that a GAAP Audit of a CLO offers protective value that outweighs the cost.

There are other circumstances where the Proposed Audit Requirement offers little or no benefit or where the cost of a GAAP Audit would exceed any incremental benefit. For example, investors in certain co-investment special purpose vehicles and co-investment funds often waive ongoing audits.[29] We understand that investors in these funds recognize that there is little protective value to a GAAP Audit during the life of the fund.[30] Investors in funds-of-one often have bespoke, negotiated information rights that allow for appropriate oversight of the adviser and, therefore, might not desire a GAAP Audit, which would incur additional costs. Similarly, in early-stage venture investing, it is often difficult to value assets in a manner that is consistent with U.S. GAAP. Management fees for such funds are typically paid on the basis of capital commitments and sometimes "step down" based on capital contributions; thus, fees are not impacted by changes in valuations. For that reason, it is typical for investors in early-stage venture funds to waive or not

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28 In our experience, advisers might not be aware that an event will lead to a U.S. GAAP valuation issue until after the audit has commenced. Additionally, it is not uncommon, particularly near the end of a fund's life, for a fund to hold one or more assets that are illiquid and cannot be valued in accordance with U.S. GAAP. If the Proposed Audit Requirement is adopted, we would suggest (at a minimum) an exception that allows investors to approve the waiver of U.S. GAAP valuation with respect to such assets, provided that the adviser has made full and fair disclosure of the circumstances.

29 Often, co-investments are structured through a special purpose vehicle or co-investment fund, rather than as direct investments into the portfolio company, as a result of the portfolio company's capitalization table. In many instances investors and other counterparties such as lenders will require the portfolio company itself to deliver a GAAP Audit.

30 Instead, we understand that investors in these funds typically negotiate for a liquidation audit to ensure that there was proper accounting of expenses and distributions.

negotiate for a GAAP Audit, opting instead for a less expensive tax-based audit. In fact, for most closed-end funds, opportunistic valuation would have little direct financial impact on investors. Valuation plays a limited role in the operation of most closed-end funds until there is a liquidation or distribution and particularly if the adviser is distributing a mixture of cash and in-kind assets. In these cases, investors might prefer not to have the fund subject to annual GAAP Audits but instead to require only that an audit be performed at liquidation.

With respect to non-U.S. advisers to non-U.S. funds that could be deemed to technically be private funds (*e.g.*, UCITS funds offered to U.S. persons), the Proposed Audit Requirement also could be unduly burdensome. In a number of cases, the Advisers Act and the SEC do not require compliance with certain requirements by an offshore adviser with respect to its non-U.S. clients. For example, the Custody Rule applies to non-U.S. advisers only as to their U.S. clients and, as a result, these advisers do not rely on the audit approach for their offshore funds. Nonetheless, most such funds are audited, and these audits must comply with local standards (including as to auditor independence) that differ from the standards that would be imposed by the Proposed Audit Requirement. The financial statements for these funds are generally presented in accordance with local standards, which can differ from U.S. GAAP. If the Proposed Audit Requirement is adopted, and no exception or flexibility is granted for these circumstances, the foreign fund would need to have an auditor that meets the independence requirements of Regulation S-X and that is engaged based on the periods dictated by Regulation S-X, and it would have to reconcile its financial statements to U.S. GAAP (or, prepare separate financial statements under U.S. GAAP if the local standards that fund investors and/or regulators expect or require to be employed are not substantially similar to U.S. GAAP). We have observed that independence standards vary, sometimes substantially, across jurisdictions. Should an offshore fund (such as a UCITS fund that is often a retail product in other markets but can be offered periodically into the U.S.) become subject to the Proposed Audit Requirement, the Proposed Audit Requirement could impose substantial additional expenses in preparing and/or reconciling financial statements. In some cases, it would not be possible to find an auditor that meets all necessary independence standards. As a result, sponsors of these types of offshore funds may decide not to open these funds to investment from investors in the United States. We believe that any final rule should not apply in these circumstances, or, at a minimum, that flexibility otherwise be granted to minimize the impact that differential independence or presentation requirements would otherwise have on these funds and advisers.[31]

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31 For example, a final rule could provide that private funds meeting certain criteria can rely on local independence and presentation standards or could offer an exception where the number of, or value of investments by, U.S. investors is *de minimis*.

For all of these reasons, we are concerned that a blanket requirement for all private funds to undertake a GAAP Audit, that offers no alternative where the circumstances clearly reflect that a GAAP Audit is inappropriate or unobtainable nor any flexibility to allow advisers (and investors) to tailor arrangements to provide appropriate equivalent protections in light of the private fund's circumstances, would result in increased costs and, in some cases, prevent registered advisers from using certain structures, pursuing certain strategies or retaining certain investments, in a private fund. These costs and lost opportunities would not outweigh the minimal, if any, added benefit that a GAAP Audit would provide to most investors. Promoting market negotiations between advisers and sophisticated investors as to whether and how a private fund should be audited is preferrable to a regulatory, one-size-fits-all approach for an industry that presents this degree of variety and diversity. Thus, we believe that the SEC should not adopt the Proposed Audit Requirement. If the Commission (against our counsel) does adopt a requirement, we believe that it should be disclosure-based and focus on: (i) whether a private fund will be subject to an audit or review; (ii) what reporting will be provided; and (iii) a description of the nature and extent of the audit or review. If an audit or third-party review is to be required, it should be structured in such a way as to allow fund expenses to be reduced by eschewing a GAAP Audit, waiving certain elements of U.S. GAAP, establishing initial or final fiscal periods of a length that would eliminate auditing a stub period[32] or agreeing to a more tailored, AUP approach to third-party review of a private fund.

III. <u>Certain Other Prohibited Transactions</u>

As a foundational matter, we remind the Commission that the Advisers Act (including the private fund regulatory framework created thereunder) does not establish a system of merit regulation or a detailed, prescriptive regulatory regime such as the 1940 Act. Rather, the Advisers Act establishes a regulatory pattern that reinforces and fills in the gaps in market-determined outcomes, primarily through disclosure requirements and by defining the scope of and enforcing flexible fiduciary principles. Even the most prescriptive elements of the Advisers Act are best understood in this light. For example, the principal transaction provisions of Section 206(3) are based on a model of informed consent, unlike the detailed proscriptions of Section 17 of the 1940 Act. Other prescriptive provisions, such as the restrictions on performance fees in Section 205 and the rules thereunder, reflect a policy of protecting the subset of unsophisticated and under-resourced investors from fee arrangements that they may not understand or have the leverage to effectively bargain over. Thus, the fundamental structure of the Advisers Act framework, both generally and

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32 For example, under the Proposed Audit Requirement, a fund that is launched late in a fiscal year would require an audit of only the initial stub period in order to assure that future audits follow a twelve-month cycle. Stub periods often have more limited activities, and the benefit of a stub period audit is likely to be in excess of costs. If the Proposed Audit Requirement is adopted, the flexibility we would suggest could include the ability for a private fund to elect a longer initial fiscal year (with appropriate disclosure to investors).

as it relates to private funds, is built on and reinforces market-determined bargains and outcomes. This long-standing structure, and the Commission's careful stewardship of it, have provided regulatory confidence and flexibility to allow the hedge fund, private equity fund and other private fund markets to flourish and grow and to serve the needs of many thousands of sophisticated private fund investors.

In such a well-functioning market-oriented system, where the primary participants are sophisticated and well-resourced parties, the range of negotiated outcomes, contracts and arrangements generally will reflect the efficient allocation of benefits, fees, costs and risks that the parties have bargained for and are willing to bear. Thus, we believe that the starting position for any proposed change to this system should be a heightened presumption against disrupting or overturning these contracts and arrangements. For the reasons we set forth below, we believe that many of the Proposed Rules do not clear this bar.

Each fund's organizational document (such as a limited partnership agreement or a limited liability company agreement) is of course such a contract; it applies to the parties who negotiated the contract, and typically, the potential limited partners have the ability to negotiate its terms. If the terms are not negotiated to the satisfaction of a limited partner, the limited partner need not sign the contract and become a private fund investor.[33]

By definition and in practice, a limited partner of a private fund is a sophisticated investor and will often be an institutional investor.[34] Most institutional investors have a highly-experienced staff,

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33 Although there are a number of organizational forms used by private funds, we will follow the industry convention and refer to them and their participants using the terminology of limited partnerships.

34 A private fund is an issuer that would be an investment company, as defined in Section 3 of the 1940 Act, but for Sections 3(c)(1) or 3(c)(7) of the 1940 Act. *See* Advisers Act Section 202(a)(29) (describing exemptions for offers of securities that do not involve a "public offering"). In particular, "[p]rivate funds generally rely on Section 4(a)(2) and Rule 506 to offer and sell their interests without registration under the Securities Act." Accredited Investor Adopting Release at 64243 n.111. While Regulation D permits issuers to sell securities to a limited number of non-accredited investors, the Commission has previously noted that "private funds generally do not offer interests in funds to non-accredited investors[.]" Proposing Release at 16939 n.255.

The Commission has frequently stated that the definition of accredited investors is intended to capture financial sophistication. Historically, the Commission used wealth as a proxy for financial sophistication, but in 2020, the Commission expanded the pool of investors eligible to invest in private funds when it revised the definition of "accredited investor" by issuing final rules "tailored to permit investors with reliable alternative indicators of financial sophistication to participate in such investment opportunities, while maintaining the safeguards necessary for investor protection and public confidence in investing in often bolstered by a team of outside consultants and legal counsel and, in many cases, subject to board oversight. In addition, where the end recipient of any private fund gain or loss is ultimately a retail investor, it is our experience that they become so typically through a pension plan. Plans benefit from board and/or trustee oversight, and managers of plan assets generally are subject to a prudent person standard of care. It is our experience that persons investing on behalf of pension plans are some of the most sophisticated and well-resourced of private fund investors and, as we discuss in more detail below, have the capabilities to level the field for all private fund investors. The Proposed Rules will increase these investors' costs, which will ultimately be borne by plan participants and other beneficiaries, and could cause such investors to pursue alternative structures or markets, to the potential detriment of their beneficiaries and of other private fund investors.

As discussed in more detail below, in our experience, primary areas of focus for private fund investors and private fund advisers in negotiations with each other include fees and discounts, governance rights, expense allocations, co-investment rights and risk allocations. Private fund investors will frequently trade off their rights under fund documents for fee discounts or other more favorable (to the investors) arrangements. In our experience, emerging fund managers who have relatively little bargaining power frequently attempt to attract investors to invest in their first private fund by providing discounted management and/or performance fees. Sometimes the management fees that emerging private fund advisers offer are low enough that the advisers may not be able to "keep the lights on" and thus must request a higher management fee rate from subsequent funds to continue to operate. Restrictions on charging certain fees and expenses to private funds will increase the cost burden on such new fund managers or smaller fund managers that are not yet able to operate at scale. Increasing a private fund adviser's cost burden creates a barrier to entry for new fund managers, which could in turn inhibit innovation and the entry and success of more diverse managers in the asset management industry. The historical precedent of the securities laws and SEC enforcement actions has been to focus on full and fair disclosure, not to invalidate fairly negotiated contracts.

A. <u>Fees for Unperformed Services</u>

Proposed Rule 211(h)(2)-1(a)(1) would prevent investment advisers from charging to a portfolio investment fees assessed for monitoring, servicing, consulting, or other services in respect of any

areas of the economy that disproportionately create new jobs, foster innovation, and provide for growth opportunities." Accredited Investor Adopting Release at 64235.

services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment (referred to as “accelerated payments”).[35]

Depending on the strategy, investments and reporting agreed to with private fund investors, a private fund adviser will and sometimes must commit significant resources to monitoring, servicing and consulting with portfolio investments, which we believe to be in the best interest of private fund investors. For instance, private fund advisers often hire third parties, such as executives with specialized skills, to perform these services on behalf of the fund. Accelerated monitoring fees are a means by which to guarantee a certain level of compensation to talented executives for committing to a job. Accelerating monitoring fees can occur upon a triggering event (*e.g.*, disposition of an underlying asset), as agreed to in the fund’s governing documents, and can allow the private fund adviser and/or executive to recapture sunk costs for these commitments, as well as to achieve the anticipated, negotiated return from providing these services for compensation. In addition, if the private fund adviser were not allowed to accelerate these payments, it could have an incentive to avoid triggering events, which in many cases can be an early disposition of the portfolio company that is highly profitable to the fund and its investors. Thus, acceleration clauses serve to align the private fund adviser’s interests with those of the fund and its investors.

Accelerated payments with respect to one or a small portion of a private fund’s investments will not necessarily reduce the fund’s return on invested capital when viewed on a holistic basis. In pursuing the private fund’s investment objective, which frequently includes a targeted return, the private fund adviser will calculate the investment return net of fees, regardless of whether fees are accelerated or accrued, in making the decision of whether and when to dispose of an investment. We believe that most sophisticated investors that are qualified to invest in private funds are familiar with and willing to pay fees incurred in monitoring and consulting services to achieve a higher return on an after-fees basis. While many investors do not permit private fund advisers to accelerate such payments, private fund advisers and investors in private funds should remain free to contract for situations in which acceleration of such payments is appropriate in the context of the risk and return profile of the private fund.

In practice, the proposed prohibition would have unintended consequences. While the Proposing Release acknowledges that this prohibition would not apply to management fee offsets, private funds with a 100% management fee offset would not be able to comply with the Proposed Rule if there are fees retained by the private fund adviser beyond the threshold where there are no further management fees to be offset. If the Commission adopts the Proposed Rules (against our counsel),

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[35] Proposed Rule 211(h)(2)-1(a)(1).

it should clarify that an adviser can continue to be in compliance with the Proposed Rule in this scenario.

In addition, that the adviser should "reasonably expect" to provide services is not the appropriate standard because of the risk that a manager will be second-guessed afterwards. Thus, if the Commission adopts the Proposed Rule, we recommend that this standard be modified to make clear if the party making this judgment does so in good faith based on the available information at the time the agreement for the services is made, they have complied with the rule.

Accordingly, we do not believe that the proposed prohibition on charging fees for unperformed services is necessary, appropriate or good policy. Many private fund advisers have been efficiently committing resources in monitoring, servicing and consulting to maximize return for their investors. We believe the sophisticated investors investing in private funds understand and recognize the value of these services.

However, if the SEC adopts this restriction, then the Commission should allow private fund advisers to accelerate fees if the private fund adviser and private fund comply with certain disclosure, governance, and/or other conditions (*e.g.*, approval by the fund's limited partner advisory committee), which would bolster the parties' abilities to contract in their own interests.

B. Fees Associated with an Examination, Investigation or Regulatory Compliance of Advisers

Proposed Rule 211(h)(2)-1(a)(2) would prevent investment advisers from charging funds for fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities, as well as regulatory or compliance expenses or fees of the adviser or its related persons.[36]

As discussed above, expense allocation terms, including those relating to regulatory expenses, are subject to contractual negotiation and in our experience, are some of the most closely and commonly negotiated terms. In practice, there is a high degree of transparency and due diligence around these expenses, and thus they are a paradigmatic case of the types of expenses that sophisticated parties should be able to determine whether to bear through negotiation.

Prohibiting a private fund from bearing these types of expenses would disrupt the fee and expense allocation bargains set by countless fund advisers and investors, who set the adviser's management levels taking into account their agreement over expense allocations. In addition to the inequitable

36 Proposed Rule 211(h)(2)-1(a)(2)-(3).

effect of this government reallocation of money, in the long run it likely will not actually result in overall lower fees and expenses. Advisers that can no longer allocate these expenses to these funds will negotiate for higher management fees.

The Commission asserts that allocating regulatory expenses to a fund harms investors because it creates an incentive for an adviser to "unfairly allocate expenses to the fund, even where fully disclosed." The reasoning in this assertion is circular: the allocation of these expenses to the fund is not unfair if it is fully disclosed and thus agreed to by the fund's investors. More importantly however, in our experience investors understand what they are agreeing to in these expense allocation provisions, and they believe that regulatory expenses can properly be a fund expense.[37]

Much of the Advisers Act regulatory regime is a form of indirect regulation of private funds through the adviser. That is, Congress and the Commission have decided, rather than regulating private funds directly through a specific statute such as the 1940 Act, to regulate the activities of private funds indirectly through the application of the Advisers Act framework to the private fund adviser. This reasoning applies to much of the regulatory compliance activity of the adviser (and to the related expenses), such as implementing and maintaining a compliance program and responding to and undergoing an examination by Commission staff. Under similar logic, Form PF allows the Commission to monitor the potential systemic risk of fund investment activity in the same way that Form N-PORT does for funds registered under the 1940 Act. Form ADV provides Commission-mandated disclosures of investment strategies and risks that have their closest analog in registered funds' mandatory prospectus disclosures under the instructions set forth in 1933/1940 Act forms such as Form N-1A and N-2.[38] It is widely accepted market practice for registered funds to bear the expense of preparing and filing these forms. Therefore, it is not surprising and entirely consistent with a well-functioning market that private fund investors are willing to and often do agree to similar expense allocation terms.[39]

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37 A high-quality and well-resourced compliance function benefits fund investors. If the Proposed Rule is adopted and investors can no longer choose to bear a portion of these expenses, the quality and expertise of an adviser's compliance department could be diminished.

38 Some funds that have investors located in the European Union ("*EU*") also must file analogous forms under the EU's private fund regulatory regime, the Alternative Investment Fund Managers Directive ("*AIFMD*").

39 We hope that the irony is not lost on the Commission that much of the Proposed Rules that we are addressing in this letter and much of the Commission's companion proposal to augment Form PF reporting obligations would represent a significant and costly expansion of the Commission's indirect regulation of private funds through their advisers.

For these reasons, we believe that the proposed prohibition against allocating regulatory compliance expenses to private funds is not necessary to protect investors and would be highly disruptive to many private funds and their advisers and investors that have reached a different economic bargain. We recommend that the Commission not adopt these Proposed Rules. However, if the Commission moves ahead, we recommend that the Commission not prohibit a private fund or its investors from bearing expenses associated with regulatory compliance obligations that indirectly regulate the private fund, such as Form PF and similar filings related to private funds, and AIFMD filings.

C. Prohibition on After-Tax Clawback of Carried Interest

Proposed Rule 211(h)(2)-1(a)(4) would prohibit an investment adviser from reducing the amount of any clawback of carried interest by actual, potential, or hypothetical taxes applicable to the general partner, its related persons, or their respective owners or other interest holders. "Adviser clawback" is proposed to be defined as any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements.[40] "Performance-based compensation" is proposed to be defined as allocations, payments, or distributions of capital based on the private fund's (or its portfolio investments') capital gains and/or capital appreciation.[41]

We believe that prohibiting after-tax clawbacks would not necessarily achieve the desired result of causing general partners to shift to pre-tax carried interest clawbacks. The after-tax general partner clawback of carried interest (whether at the end of a fund's life or the end of some earlier interim period) is essentially a contractual allocation of the risk of investment losses between the general partner and limited partners. General partners may seek alternative ways to allocate the risk of investment losses if after-tax clawbacks are prohibited, which could ultimately be more costly or less advantageous to private fund investors.

Further, contrary to the numerical example of an after-tax clawback of carried interest set forth in the Proposed Rule, a typical general partner clawback on carried interest limits the amount of excess carried interest that is clawed back to the total amount of carried interest received by the general partner over the life of the fund less (deemed) taxes. The numerical example set forth in the Proposed Rule assumes that the amount clawed back will be the excess carried interest less deemed taxes. Accordingly, if the excess carried interest that the general partner has received is $10 and the

40 Proposed Rule 211(h)(1)-1.

41 *Id.*

assumed tax rate is 30%, then the amount clawed back, per the example in the Proposed Rule, will be $7. However, in practice under a typical general partner clawback, this is only correct if the total amount of carried interest that the general partner received is $10. If, instead, the general partner received $15 of carried interest throughout the life of the fund, and the excess carried interest that it is required (without taking into consideration taxes) is $10, then the general partner will be required to return the entire $10 since the limit on the amount required to be returned is $10.50 (*i.e.*, the clawback amount is the lesser of (x) excess carried interest and (y) total carried interest less deemed taxes).

Long-dated private equity funds constitute only a very small portion of the market. Some of these long-dated private equity funds (with longer than typical terms and holding periods for investments) use deal-by-deal waterfalls to compensate investment team personnel who share in the carried interest distributions as individual deals are realized, meaning that the fund sponsor receives carried interest from the underlying individual investments in the fund before limited partners are made whole, instead of waiting until all funded capital commitments plus the preferred return are returned to limited partners.

Moreover, the Proposed Rule could disproportionately impact certain emerging managers and smaller fund sponsors, who often have fewer resources and are less likely to have additional cash on hand to be able to assume the risk of returning cash distributions for amounts spent to satisfy tax liabilities on carried interest while awaiting returns. In addition, a profits interest clawback may in many cases be nondeductible to the fund sponsor and arise when amendment of prior years' tax returns is not available, resulting in income tax with no corresponding net cumulative profit.

Prohibiting after-tax clawbacks could also trigger more escrowed carried interest arrangements or deal-by-deal waterfalls with outperformance triggers. Some fund sponsors will consider replacing the general partner clawback entirely with escrow arrangements for carried interest. Other fund sponsors might, in lieu of having a general partner clawback, require the achievement of certain return thresholds on realized and unrealized investments (*i.e.*, outperformance triggers) before the general partner is allowed to take carried interest on a particular deal. Finally, some fund sponsors will simply delay receipt of carried interest distributions they are otherwise entitled to receive. Delaying distributions of carried interest would have a greater adverse impact on newer fund sponsors, who are more likely to need carried interest distributions (for operating capital or funding other investments in their fund management business and other private funds they sponsor). It also has an impact on operating partners or venture partners who are paid through the carried interest for their work to the fund. Operating partners and venture partners are often compensated based on the returns from their work on a particular investment. Accordingly, delaying the distribution of carried interest to the general partner will also likely mean delaying the compensation of operating and venture partners, which will likely result in the industry seeking alternative compensation or revenue sharing arrangements. The fund, and hence fund investors, are better off when returns to sponsors and operating and venture partners are tied to performance.

As discussed above, the Proposed Rule would negate the freedom to contract. For fee provisions among fund sponsors and sophisticated investors, the Advisers Act and the Commission have focused on full and fair disclosure and have not imposed specific contractual terms, and we believe that it is unwarranted for the Commission to do so through this Proposed Rule.

D. Limitations on the Ability of Investors and Advisers to Negotiate Indemnification, Exculpation and Liability Provisions

The regulatory regime that Congress created for private funds and their investors deliberately allows for a wide scope of negotiation over the key terms of fund organizational documents. Congress recognized that private fund investors are generally sophisticated parties with resources and access to the expertise necessary to define the terms of their relationship with a fund and its adviser in a manner that is consistent with the best interests of the parties. A premise of this regulatory regime is that sophisticated parties, when full and fair disclosure is provided, generally are able to determine how to realize those interests, including in the allocation of economic and legal risks between investors and the adviser. The apportionment of risk between sophisticated investors and advisers is a critical element of negotiation between private fund investors and advisers, and as we describe below, interrelated with negotiations over other terms, including compensation. Investors' and advisers' ability to negotiate most aspects of the relationship between the adviser and the fund allows for flexibility and innovation; and in doing so, advisers are subject to, and investors are protected by, fiduciary duties that require full and fair disclosure of material conflicts.[42] Even where a particular prospective investor is not involved directly in the negotiation of fund terms, so long as the terms of the fund are clearly stated and disclosed, each prospective investor can determine for itself whether the terms as a whole are acceptable. Thus, no investor is compelled to bear the terms of a fund: an investor can always decide to not invest.

Under current law and market practice, private funds' organizational documents commonly include exculpation (limitation of liability) and indemnification provisions that are intended to allocate the costs and risks of potential adverse events between the adviser and the fund. These provisions are

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[42] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Interpretive Release, SEC Rel. No. IA-5248, 84 Fed. Reg. 33669 at 33672 (July 12, 2019) ("*Standards Release*"). As noted below, even with respect to "hedge clauses," the Standards Release is clear that the "application [of an adviser's federal fiduciary duty] may be shaped by agreement."

generally based on concepts of the duty of care under state law[43] and, in many cases, are based on a gross negligence standard of conduct. Proposed Rule 211(h)(2)-1(a)(5) would prohibit investors from agreeing that an adviser can directly or indirectly "seek reimbursement, indemnification, exculpation, or limitation of its liability by the 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."[44]

1. Exculpation and Indemnification Provisions are Designed to Allocate Investment Risks between the Fund Manager and Sophisticated Investors, not to Erode the Federalist Standard

It appears that this Proposed Rule is based on a misunderstanding of the purpose and effect of exculpation and indemnification provisions. Far from eroding the federal standard of care under the Advisers Act, these provisions are properly negotiated to allocate risks between investment advisers and sophisticated investors investing in the funds advised by them, in a manner that is consistent with the nature of the fund and the interests of the parties. Exculpation clauses are primarily intended to allocate financial liability for investment losses between an investment adviser and investors in the funds advised by it, and they allow investors and advisers to do so in a manner that takes into account, among other matters, the risks associated with the funds' particular investment strategies and techniques, which inherently both reflects and influences the compensation paid by investors and the potential revenues for the adviser.

The Proposing Release does not sufficiently address the connection between the adviser's compensation and the allocation of risk.[45] Rather, the Proposing Release suggests that negotiation

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[43] In the Standards Release, the SEC wisely refrained from commenting on "the scope or substance of any fiduciary duty that applies under applicable state law," instead focusing on whether an exculpation or similar provision is misleading and noting that the "question of whether a hedge clause violates the Advisers Act's antifraud provisions depends on all of the surrounding facts and circumstances, including the particular circumstances of the client (*e.g.*, sophistication). . . . . [but t]o the extent that a hedge clause creates a conflict of interest between an adviser and its client, the adviser must address the conflict as required by its duty of loyalty." Standards Release at 33672 n.31. We submit that for private funds, which are available only to sophisticated investors, the approach taken in the Standards Release is the more appropriate.

[44] Proposed Rule 275.211(h)(2)-1(a)(5).

[45] The Proposing Release does request comment as to whether "commenters believe that the proposed rule would increase operating expenses for advisers." We believe the answer to this question is, unequivocally, yes. The costs will be evident in insurance premiums and in defending suits that likely would be more frequent and costly if the Proposed Pule is adopted in the current form. In the Proposing

that results in an adviser's ability to seek reimbursement, indemnification, exculpation, or limitation of its liability, "even when disclosed and permissible under state law, may involve breaches of fiduciary duty to the fund or investors, and possible harms to investors, and so investors will likely benefit from their prohibition."[46] To the contrary, fund investors and advisers frequently negotiate the standard of conduct in fund organizational documents contemporaneously with the compensation of the fund manager, implying that investors and advisers are determining the manager's compensation in part based on how they are allocating risk.[47]

The most common standard of conduct that private fund investors and advisers set in fund organizational documents is gross negligence. A gross negligence standard in an exculpation provision reflects a determination that liability should not attach unless the investment adviser's (or its employees' or agents') conduct is grossly negligent or more serious. In an indemnification provision, the standard means that the investment adviser will be indemnified against legal costs and damages arising from its management of the fund unless its conduct is grossly negligent or more serious.

Gross negligence is a common and accepted standard of conduct in the U.S. because it does not impose liability for ordinary market losses. In contrast, a simple negligence (or even lesser) liability standard creates the risk that a dissatisfied, potentially unreasonable, investor could sue for ordinary market losses, claiming negligence, which could burden the adviser with the time and cost of litigation and threaten the viability of its business. This risk is especially salient for emerging and smaller private fund adviser, who have fewer resources to defend themselves, and for managers with more innovative strategies. This risk is also particularly significant for advisers managing quantitative and algorithmic strategies if investors were to claim that investment losses are the

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Release, the Commission stated that "[t]hese benefits may be diminished to the extent that advisers are able to obtain alternative permissible sources of compensation for these expenses from investors (for example, from increased management fees), although this ability would likely be limited." Proposing Release at 16951. We would expect that these increased expenses will, over time, result in increased fees for investors.

46 Proposing Release at 16951. We note that while the SEC has stated that "an adviser's federal fiduciary duty may not be waived," the SEC has also recognized that the duty "will apply in a manner that reflects the agreed-upon scope of the relationship." Standards Release at 33672 n.29.

47 Contrary to the SEC's suggestion in the Proposing Release that "investors with less bargaining power are forced to bear the brunt of such arrangements," we believe that when the liability, indemnity and exculpation terms are clearly stated, no investor is required to bear the brunt of any such term because no investor is compelled to invest. Proposing Release at 16925.

result of incorrect code or algorithms. A gross negligence standard renders a claim of this sort much less likely to be frivolously asserted and harder to sustain.

Indemnification clauses are primarily intended to partially allocate, not entirely shift, the risk of loss from litigation (including legal fees, which can be substantial) by investors and third parties such as creditors or other counterparties of the fund or of the companies in which a private fund invested. The size of potential losses in such litigation also can be disproportionate to the revenues and profits of many private fund advisers, including where the potential cost or recovery is derived from the amount of assets and leverage in the fund. In many cases, especially where a lawsuit is tenuous or specious, litigation could threaten the viability of an adviser, even one which is sizeable and established. As a result, advisers and investors, in agreeing to such provisions, have concluded that it is reasonable for the private fund to bear the risk of litigation where allegations do not meet a gross negligence standard rather than causing the adviser to bear the costs associated with any claim that an investor or third party might bring.

We agree that, as stated in the Proposing Release, "a waiver of an adviser's compliance with its Federal antifraud liability for breach of fiduciary duty to the private fund or with any other provision of the Advisers Act or rules thereunder is invalid under the Act,"[48] However, we do not believe that a gross negligence standard for exculpation and indemnification is, in the context of a private fund's negotiated governing documents, inconsistent with or represents a "waiver" of the federal standard of care.

Investment advisers are well aware of their fiduciary duties to the private funds that they manage. Further, investment advisers are aware that while there is only a limited right of private action under the Advisers Act,[49] the fiduciary duties are enforced by the full might of the Commission—including the remedies of disgorgement, penalties, public reputational damage and even deregistration or a bar from association with a registered investment adviser or from working in the securities industry.[50] Indemnification and exculpation clauses are intended to allocate liability for purposes of private litigation, not under the Advisers Act. The fact that a fund's investors have determined to accept liability for certain losses based on a gross negligence standard does not

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48 Proposing Release at 16925.

49 *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977), *aff'g* in part and *rev'g* in part 392 F. Supp. 740 (S.D.N.Y. 1975).

50 In the Matter of Diastole Wealth Management, Inc. and Elizabeth D. Eden, Investment Advisers Act Release No. 5855 (Sept. 10, 2021) (settled action); and In the Matter of Peter J. DeCaprio, Investment Advisers Act Release No. 5732 (May 10, 2021) (settled action)**.**

change the incentive to comply with the Advisers Act in any meaningful, let alone material, way. As practitioners, we are witnesses to this effect on a daily basis.

2. The Standard of Care in Exculpation and Indemnification Provisions is Subject to Negotiation by Sophisticated Investors

As noted above, the standard of care in exculpation and indemnification provisions in private fund operating documents are generally subject to negotiation between the investment adviser and sophisticated investors in the private fund, a purposeful and functioning system that the Proposed Rule threatens to disrupt. Many investors in private funds (including the initial and/or seed investors) can and often do negotiate over the standard of care in fund operating documents. Moreover, particular terms generally are not negotiated in a vacuum. In determining how and what to negotiate for, the parties consider the terms of the fund as a whole. Limitations on the ability to negotiate any one term therefore will have an impact on the negotiation of other material terms, including compensation of the adviser.

There is, and has long been, significant competition among private fund managers for investors' capital. As such, private fund investors generally have negotiating power, and the fact that many negotiated fund documents reflect a gross negligence standard indicates that a gross negligence standard is reasonable and fair, that is, within the range of provisions that rational counterparties would negotiate at arm's length. In industry parlance, these provisions are "market," *i.e.*, accepted by investors and managers alike as within the range of common allocations of risk and reward. In our experience, investors often negotiate over indemnification and exculpation provisions. Those negotiations are evidence that the parties understand such provisions and are capable of agreeing to them and living with their consequences. Even if there are some investors that are not sophisticated enough, or do not have enough resources to retain advisors, to fully understand these provisions (or they are otherwise not in a position to negotiate them), they will get the benefit of the negotiations by other investors in the fund and in the market. Moreover, even for investors who do not participate in the initial negotiation (*e.g.*, in an open-end fund when buying into a fund whose terms were negotiated prior to the initial closing), there is significant power in being able to review fund terms and disclosures and determine whether to invest.

Thus, when taken together with the other relevant terms of the fund, a gross negligence standard for indemnification or exculpation essentially represents a bargain that investors will not compensate the fund manager for bearing the risk of liability of fund losses and litigation caused in part or whole by alleged negligence by the manager, and that the manager will not bear these risks.

The Commission's proposed prohibition, if adopted, therefore would disrupt and remake countless negotiated bargains between sophisticated private fund parties allocating risk and reward, essentially reallocating the risks that investors had agreed to bear without compensating the fund manager for taking them on. This tilting of the playing field toward certain (but not all) investors would be an unprecedented and unfair government interference in private fund markets on a massive scale. Further, the brunt of this government reallocation of risk and reward would fall on smaller and mid-sized managers, who would have fewer resources to purchase insurance or to self-insure against these new risks and on managers with innovative strategies who might be less able to price risk if a gross negligence standard is prohibited. Thus, this rule would have the effect of increasing concentration and diminishing competition and innovation in the private fund industries and, likely, will result in an increase in fees charged to fund investors.

3. The Commission's Proposal, if Adopted, Would Usurp the Role of the Individual States in our Federalist System

Private funds, like other issuers of securities in the U.S., are organized under and governed by state law. As we describe below, Congress has neither granted the Commission authority nor imposed a policy mandate to supplant the central role of state corporate, partnership and limited liability company laws in establishing the basic organizational relationships between investors and advisers, in the Advisers Act or otherwise. Certainly, the most recent significant amendments to the Advisers Act, enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 "*Dodd-Frank Act*"), which brought most private fund managers into the Advisers Act regulatory regime, did not include such authority or mandate and thus are a clear indicator of Congress's intent. Delaware is the primary U.S. jurisdiction under whose laws private funds are formed. Under Delaware law, gross negligence is the standard of conduct for the fiduciary duty of care.[51] The

51 *See, e.g., Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) ("[t]he standard of care applicable to a director's duty of care . . . is predicated upon concepts of gross negligence" andquoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)); *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 651 (Del. Ch. 2008) (")[e]ven where it is possible to hold directors responsible for a breach of the duty of care, Delaware law requires that directors have acted with gross negligence") (citing *Aronson*, 473 A.2d at 812); *Trs. of Gen. Elec. Pension Trust v. Levenson*, Civ. A. No. 12,014, 1992 WL 41820, at *3 (Del. C. Mar. 3, 1992) (holding for a limited partnership, "in order to state a claim for breach of the duty of care, one must allege conduct that amounts to gross negligence"); 12 Del. C. Section 3806(l) ("[e]xcept to the extent otherwise provided in the governing instrument of a statutory trust, trustees of a statutory trust that is registered as an investment company under the Investment Company Act of 1940 . . . shall have the same fiduciary duties as directors of private corporations for profit organized under the general corporation law of the State"); 6 Del. C. Section 18-1104 (providing that for limited liability companies, "[i]n any case not provided for his chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern").

exculpation and indemnification clauses of the type outlined above thus align with the fiduciary duties established under the law of the predominant jurisdiction in which U.S. funds are organized.

The specific provisions of the Advisers Act under which the Commission proposes to adopt the Proposed Rule—Sections 206(4) and 211(h)—do not contain a grant of authority or mandate to remake the U.S.'s federalist system. Such authority is not found in Section 206 of the Advisers Act, which prohibits fraud or practices that are fraudulent, deceptive or manipulative. A fully disclosed standard of conduct that is consistent with a bedrock principle of the state in which the private fund is organized is not fraudulent, deceptive or manipulative. Nor is it found in Section 211(h), which was added to the Advisers Act by the Dodd-Frank Act and clearly was intended to regulate conduct relating to retail investors, not private funds. This Section empowers the Commission to prohibit or restrict sales practices, conflicts of interest and compensation schemes that it deems to be contrary to the public interest and the protection of investors. However, indemnification and exculpation clauses are not compensation schemes or sales practices; moreover, if they are deemed to represent a conflict of interest, then any allocation of risk and reward between private fund investors and fund managers is a conflict of interest. This argument, relying on a single phrase buried in the Dodd-Frank Act, would purportedly give the Commission authority to prohibit any practice, even if this practice is expressly authorized by state law. This cannot have been Congress's intent.

Thus, the Proposed Rule, if adopted, would not just supersede state law but would disrupt the federalist system of law and regulation that private funds and their investors have flourished under for decades, and would do so based on questionable authority.[52]

A more appropriate approach is exemplified by the Commission's historical stance toward so-called "hedge clauses," under which the Commission gets much closer to the federal/state balance that Congress has consistently struck. Commission and Staff statements on "hedge clauses" have focused not on whether such provisions are legal or appropriate (which they clearly can be under state law), but rather on whether investors will be misled about the fund manager's fiduciary obligations under the Advisers Act.

While we understand the Commission's concerns about the potential for "hedge clauses" to mislead retail investors, for all the reasons we note above, we believe that sophisticated and institutional investors of the kind that represent a significant majority of the capital invested in private funds

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52 Proposing Release at 16936 ("[f]or example, the assets under management of private equity funds reported by RIAs on Form ADV [over the last five years] grew from $2.6 trillion to $5.1 trillion, or by 96 percent. The assets under management of hedge funds reported by RIAs grew from $6.1 trillion to $8.4 trillion, or by 38 percent").

generally and fully understand the implications of the exculpation and indemnification provisions for which they have negotiated and are not misled into thinking that they are not protected by the federal standard of care. Indeed, to the latter point, many private fund investors conduct extensive due diligence on private fund managers' compliance programs, indicating that they understand investment advisers' federal duties well enough to test compliance with them in detail.

For these reasons, we believe that the Proposed Rule's prescriptions as to the standard of care in exculpation and indemnification clauses would be contrary to the public interest and the interests of investors, would disrupt the fair, orderly and efficient operation of the private capital markets, and would impede capital formation and fair competition. We urge the Commission to not adopt it.

E. Prohibition on Non-Pro Rata Allocation of Fees and Expenses

Proposed Rule 211(h)(2)-1(a)(6) would prohibit an adviser from charging or allocating fees and expenses related to a portfolio investment on a non-*pro rata* basis when multiple clients advised by the adviser or its related persons have invested in the same portfolio investment.[53] While this Proposed Rule likely intends to ensure fairness among investors, the prescriptive nature of the Proposed Rule interferes with free negotiation between advisers and investors and ignores economic realities, which will result in unintended consequences. Non-*pro rata* allocations of fees and expenses might, in some cases, better ensure that investors more accurately bear their applicable expenses than would a strict *pro rata* allocation. For example, non-*pro rata* allocation could be more fair if a particular investment structure, tax structure and/or regulatory position or status for an investment exists solely to benefit one or more particular investors. In the absence of such circumstances, a simpler and less expensive investment structure, tax structure and/or regulatory position could have been used. In these cases, the participant(s) that are not driving and not benefitting from the structure would be required to bear a portion of the related expense under the Proposed Rule, whereas a non-*pro rata* allocation would allow those expenses to be allocated to the participants that drove the expenses of the structuring from which they benefitted. Similarly, funds that share a common underlying investment might be in different stages of their life cycle, *e.g.*, the ramp-up, investment or wind-down phases, and it is reasonable that any additional expenses of a fund that is in the investment phase be borne by investors in that fund. In addition, it is not clear whether the Proposed Rule would prohibit non-*pro rata* allocation of tax liabilities that are attributable to a specific investor (*e.g.*, withholding taxes and partnership-level assessments resulting from a tax audit). Private fund investors typically expect that a private fund, either under its limited partnership agreement or pursuant to an investor's side letter with such private fund, will provide that an investor will not be required to bear any such taxes to the extent such taxes are economically attributable to other investors in the private fund. Accordingly, non-*pro rata*

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53 Proposed Rule 211(h)(2)-1(a)(6).

allocations can help to ensure that the investor or investing client that is responsible for such additional costs bears those costs.

Moreover, in addition to applying to consummated investments, the Proposed Rule would prohibit the non-*pro rata* allocation of fees and expenses for unconsummated investments (*e.g.*, broken deal expenses). The potential that investors might be allocated such expenses incentivizes a "waiting game," where investors refuse to commit to an investment until they are sure that the transaction will not fall through. Requiring co-investors to make advance, binding commitments to a transaction would only exacerbate the "waiting game" issue. This incentive structure will likely lead private fund advisers to miss (through delay or missed investment deadlines) or not to pursue attractive investment opportunities, which would not be in the best interest of investors and would make it more difficult for issuers to raise money in the capital markets. We recognize that the Commission's goal is the fair allocation of expenses. However, because of the "waiting game" issue, no rule can force non-fund investors (who have not signed binding contractual commitments) to bear the costs of broken deals: the investors can always just refuse to participate. Thus, we believe that this goal can be achieved only through significantly diminishing co-investment opportunities. We believe that the market and investors generally understand this dynamic and have reached the conclusion that a certain amount of non-ratable expense allocation is justified by the benefits of increased potential access to co-investments.

IV. <u>Differential Treatment and Restrictions on Side Letters</u>

As explained in the Proposing Release, "[s]ide letters or side arrangements are generally agreements among the investor, general partner, adviser, and/or the private fund that provide the investor with different or preferential terms than those set forth in the fund's governing documents."[54] Investors and private fund advisers have differing levels of negotiating power with respect to entering into such agreements based on, among other factors, the amount of an investor's proposed investments, the minimum amount of total commitments that a private fund requires to be able to deploy its investment strategy effectively, the relative sophistication of the parties and the availability of alternative investment opportunities. While these differences can result in different side letter terms for different investors, for the reasons we set forth below, these differences reflect a well-functioning market accommodating investors with different needs.

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[54] Proposing Release at 16928.

A. **Certain Preferential/Different Rights Are Designed to Protect Investors, Accommodate Investor's Needs, and Comply with Legal and Regulatory Regimes**

1. Preferential/Different Liquidity Rights

The Proposing Release did not define what it means for a fund adviser to grant an investor the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors. However, we note that this provision is broad and vague enough potentially to capture a wide range of terms and practices that fund advisers currently employ to protect funds and fund investors. These practices include the use of in-kind redemptions, side-pocketing illiquid investments, and compulsorily redeeming investors for regulatory reasons. Fund managers use the first two of these practices to protect the fund and other investors in cases where certain assets of the fund become distressed and lose liquidity. Redemptions in kind and side pockets, when used judiciously and appropriately, can prevent first-moving redeemers from receiving a disproportionate share of the value and liquidity in the fund. They are thus investor protections that help to ensure that investors who are exposed to such investments are treated fairly.[55]

We note that other regulated alternative fund regimes recognize the value of these practices in protecting investors and, rather than prohibiting them, have adopted measures that focus on ensuring their fair implementation. For instance, for in-kind redemptions, the Irish alternative investment fund regime requires that an independent party sign off on the assets to be provided, to ensure that there is no cherry picking. Similarly, the Irish regime requires funds that have side pocketed assets to regularly report the values of side-pocketed assets to investors.[56]

We also note that certain liquidity rights are required by certain non-U.S. regulatory regimes. These obligations are usually satisfied through the fund providing the investor with the ability to transfer its interest or through the fund's general partner purchasing the interest. In our experience, these rights are substantially unlikely to ever be exercised. However, the proposed blanket prohibition on preferential liquidity rights would effectively bar investments by such investors, thereby depriving the fund of scale (the benefits of which the Proposing Release notes).

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55 Proposing Release at 16963.

56 Central Bank of Ireland AIF Rulebook, Chapter 2 - Qualifying Investor Alternative Investment Funds, Part 1, Section 1(v) Share Classes, side pocket share classes.

Other investors, particularly non-U.S. regulated entities, may be required to obtain the right to exit a fund if there were to be regulatory changes prohibiting certain types of investments or making an investment in a fund's strategy no longer permissible. For example, certain government-sponsored investment funds and sovereign wealth funds may expand the scope of their investment prohibitions (such as prohibiting investment in certain industries or companies) after the investor has invested in a private fund. In such circumstances, for open-end funds, the investor may be granted a right to redeem on a special (*i.e.*, not scheduled) basis or on short notice.[57] For closed-end private funds, whose assets are generally illiquid, the more common practice is to facilitate the transfer of the investor's interest through offering to other fund investors, third parties or the general partner. Other practices include allowing the investor to withdraw their interest in the fund but delaying settlement of the withdrawal until the underlying assets mature. These measures are taken precisely for the purpose of protecting the fund and other investors. However, the Proposed Rules could limit or bar advisers from employing these means of protecting a fund and its investors.

Private fund advisers sometimes use the power to compulsorily redeem certain investors selectively to benefit a fund and its investors. For example, certain funds that have more than 25% of their assets held by ERISA and certain other retirement plans are "plan assets funds" that must comply with ERISA. Complying with ERISA imposes additional restrictions and compliance costs on a fund and its adviser, and thus many investors prefer to invest in funds that are not "plan assets funds." However, under certain circumstances such as the withdrawal of non-plan investors, plan investors' capital accounts may threaten to cross the 25% threshold. In these cases, it benefits the fund and the other investors for such plan investors' assets to be compulsorily redeemed so that the fund remains below the threshold. However, the breadth and vagueness of the "material, negative effect" standard in the Proposed Rule could prevent fund advisers from using compulsory redemptions in this manner.

In some cases, seed or other large investors in a hedge fund will negotiate for different liquidity or redemption rights (*e.g.*, the right to redeem earlier or with shorter notice than set forth in fund documents) that will be triggered by specific events, such as a large investment loss that hits a certain threshold level or the departure or incapacitation of a key portfolio manager. One practice that we have seen managers follow is to allow all investors in the fund or in the same share class of the fund the right or opportunity to "piggyback" off these provisions, *i.e.*, to exercise the same liquidity or redemption rights, when they are triggered. In this way, such rights do not have a material negative effect on other investors. Piggybacking thus allows the bargaining power of large investors to be leveraged to the benefit of smaller investors. Conversely, if the SEC prohibits funds from negotiating such provisions, the likely effect will be that no investors will gain these benefits.

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57 As discussed below, such a special redemption right could also be granted to other investors through "piggybacking."

Thus, while for the reasons we discuss elsewhere in this letter we believe that the proposed preferential liquidity provisions are problematic and should not be adopted, if the SEC does adopt them, we believe that the SEC should expressly exclude different liquidity rights from the prohibition when they are subject to piggybacking.

The current disclosure- and market-based regime has allowed fund advisers the flexibility to devise and apply investor protections such as those discussed above. The proposed prohibition of Proposed Rule 211(h)(2)-3(a)(1) would eliminate this flexibility and harm private fund investors. Thus, we believe that the Commission should not adopt this aspect of the Proposed Rules. In the alternative, we would propose that the Commission adopt measures such as those in the Irish private fund regime that support the adviser's flexibility on redemption rights through governance and reporting.

2. Preferential/Different Information Rights

Private fund managers generally agree to provide fund investors with a baseline amount of information about the fund, such as annual audited financial statements, monthly or quarterly reports on the investor's capital accounts, reports provided to the limited partner advisory committee[58], reports provided by portfolio companies in which the private fund has invested, periodic reports of return information and confirmations of regulatory compliance. In addition, private fund managers commonly provide different investors with a wide variety of different types of information pursuant to side letters, in response to those investors' requests and needs. In many cases, those investors need information tailored to their own risk management systems or those of their advisers, consultants and due diligence providers, as well as pursuant to regulatory and legal requirements to which the Investor, the private fund's portfolio companies may be subject.[59] Some of the data requested can be quite granular, but it is critical to note that private fund advisers in providing this information already take into account whether doing so would materially disadvantage other fund investors. These considerations, as well as existing negotiation and disclosure obligations and practices, impose sufficient discipline while leaving the adviser flexibility to accommodate investors' particular needs.

Categorizing this practice as "preferential treatment" and subjecting the adviser to liability if it does not pass the "material, negative effect" test will chill this form of transparency, to the detriment of investors. It should be sufficient to disclose to other investors that some investors negotiate for and

58 An example of the type of reports provided to a limited partner advisory committee may include reports of reimbursements by the private fund to affiliates of the general partner in respect of legal, accounting or other services provided by such affiliate.

59 For example, periodic reports required of non-U.S. investors by the Bureau of Economic Affairs.

receive additional information, as is current practice. However, even if the Commission believes that additional regulation is needed, we would recommend a more flexible approach: treat different information rights as "other preferential treatment" requiring heightened disclosure, similar to the proposed treatment of differential fee arrangements.

In our experience, it is common for special reporting to be granted to investors that do require it to fulfill another obligation, such as regulation or to provide to underlying investors in a fund of funds. A key concern with a requirement to provide any specific type of reporting to all investors (or to provide each investor with any report that is provided to any other investor) is that there are innumerable formats and items required under various regimes on a global basis. We are concerned that a blanket prohibition on preferential transparency would result in many institutions being unable to invest, as such reporting is required by their laws or regulations, or in all investors receiving information that is effectively duplicative and/or provided in forms responsive to some investors' regulatory needs or to respond to statistical reporting regimes, but which has no relevance to, and can be confusing for, others.[60]

B. Prohibiting Investment Advisers from Entering into Side Letters will have Unintended Consequences

Given that the investor base of private funds often includes regulated institutions, an attempt to curtail any preferential treatment would result in the inability for certain such investors to invest, which would harm these investors, the private funds that would be deprived of their capital and the resulting scale, other fund investors and the wider markets.[61] As discussed above, in practice most of what the Commission is defining as "preferential treatment" is related to assisting investors in fulfilling their own obligations where these may not be the same as the obligations and needs of other investors.

Required disclosure of the specifics of different fee arrangements would likely eliminate or severely limit the ability of larger investors to negotiate larger discounts for themselves.[62] This kind of transparency is more likely to have the opposite effect than what the Commission expects: private

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[60] Proposing Release at 16931.

[61] Proposing Release at 16930.

[62] We recognize that this is clearly the SEC's intent, based on its statements in the Proposing Release. *See e.g.*, Proposing Release at 16929 ("[a]n investor can negotiate to receive certain types of information that is not widely available to all investors; however, an investor's success in obtaining such terms may depend on factors including the size of its capital commitment"). Nonetheless, we urge the Commission to reconsider this approach.

fund managers will be less likely to grant fee discounts if they know that they have to disclose them to all of their investors and prospects and thus open themselves up to a broad-based, general fee negotiation. As we discuss below, we believe that this disclosure would harm some investors without commensurate gains based on a misapprehension of the differences between registered and private fund markets.

If this Proposed Rule is adopted, the SEC would be importing standards and expectations from the registered, retail fund regulatory regime into the private, institutional market. We recognize that the Commission has long interpreted Section 18(f) of the 1940 Act to prohibit registered fund advisers from charging different advisory and administrative fees to different investors. However, this has been on the theory that registered fund shareholders are typically retail investors without the knowledge, experience or resources to negotiate for themselves, and thus there is a risk that insiders or large investors would negotiate more favorable fees for themselves that would result in smaller investors subsidizing the larger investor(s). This theoretical concern does not apply in the private fund marketplace. Private fund investors generally have the sophistication and resources to defend their interests, and even where some smaller investors may not have these resources, the multiplicity of sophisticated investors conducting diligence and monitoring and negotiating with the fund adviser will be sufficient to prevent different fee arrangements from resulting in a situation where smaller investors are subsidizing larger investors.

Moreover, in interfering with negotiations between sophisticated private parties, the SEC would be disrupting the efficiency of the private fund marketplace to the detriment of many investors and pension plan beneficiaries. In wholesale markets such as these, large buyers (*e.g.*, large investors) can and generally do negotiate larger discounts and thus lower prices or fees than smaller buyers (*e.g.*, smaller investors). In a well-functioning market, such negotiations do not mean that the smaller investors have to pay higher prices or fees; rather, they mean that the seller (*i.e.*, adviser) in charging the large buyer a lower price will spread the same amount of profit across a larger volume of purchases, *i.e.*, that its profit margin per unit will decline. To put the point in fund-specific terms, the adviser is lowering its marginal fee rate in exchange for more assets under management. Such arrangements do not change the marginal fee rates that other investors pay or that they would have paid if the large investor had not negotiated the lower rate. Thus, the Proposed Rule could result in large institutional investors (including pension plans) being unable to negotiate lower fees without benefiting other investors.

1. The Proposed Rule Should Not Apply to Existing Arrangements with Current Investors

The Commission requested comment regarding the treatment of current investors and any preferential terms which the investment adviser has provided to other current investors.[63] We believe that existing preferential terms that have not already been disclosed should be "grand fathered," *i.e.*, should not be required to be disclosed. These arrangements were reached with the general expectation of confidentiality before the Proposing Release was published, and the Commission should respect the desires of the applicable investors and advisers to maintain this discretion.

2. At What Point Does a Potential Investor Become a "Prospective Investor"?

The Commission requested comment regarding how a final rule should address disclosure of preferential terms previously provided when an investment adviser is interacting with a prospective investor.[64] Such a requirement would harm private funds and advisers if it applied to any investor that expresses an interest in investing in a private fund managed by the investment adviser; thus, we believe that any such requirement, if adopted, should be limited to prospective investors who are, at a minimum, undertaking active due diligence on the fund and are subject to a non-disclosure agreement.

3. The Proposed Material Negative Effect Standard Should Be Met by an Adviser's Good Faith

The Commission requested comment on how to shape the Proposed Rule's "material, negative effect" standard.[65] The Commission requested further comment as to whether the proposed prohibitions should be limited to "terms that the adviser reasonably expects to have a material, negative effect[.]"[66] For the reasons we discuss above, we think a set of prohibitions based on this standard is unnecessary and could end up creating an overly broad and vague standard. Such a standard would be difficult to apply in practice, and thus would unintentionally impact funds and investors without achieving the Commission's goal. We are concerned that "reasonable

63 Proposing Release at 16931.

64 Proposing Release at 16931.

65 Proposing Release at 16930.

66 Proposing Release at 16930.

expectations" and "materiality" could be applied broadly and with hindsight, in effect meaning that any term that in the future ever has any negative effect could be deemed to have violated the standard. Attempting to identify any provision that "could" have a negative effect would be an impossible exercise for an adviser. Thus, we believe that if the Commission adopts this standard (against our counsel), it should include in the rule and/or provide in guidance in the adopting release that an adviser meets the standard if the adviser, in good faith, reaches a reasonable expectation that there will not be a material negative effect based on information it has at the time of the determination (which can be supported by documentation of the reason for the expectation).

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We appreciate the opportunity to comment on the Proposing Release. If the Commission or its staff have any questions or wish to discuss the matters discussed in this letter, please contact: Sonia R. Gioseffi at [redacted] and [redacted]; Tricia J. Lee at [redacted] and [redacted]; Omoz Osayimwese at [redacted] and [redacted]; Mark D. Perlow at [redacted] and [redacted]; Mike Sherman at [redacted] and [redacted]; Lindsay Trapp at [redacted] and [redacted], or Ashley N. Rodriguez at [redacted] and [redacted].

Very Truly Yours,

/s/ Dechert LLP

Dechert LLP