April 25, 2022

<u>*Submitted electronically via SEC.gov*</u>
Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Proposed Rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews
File No. S7-03-22

Dear Ms. Countryman:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to provide comments to the United States Securities and Exchange Commission (the "**Commission**" or "**SEC**") on the Commission's proposed new rules and amendments under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") intending to enhance the regulation of private fund advisers (the "**Proposed Rule**").[2] If adopted, the Proposed Rule would:

- require that SEC-registered investment advisers ("**RIAs**") to private funds provide investors with quarterly statements detailing information about private fund performance, fees, and expenses;
- require private fund RIAs to obtain an annual audit for each private fund and cause the private fund's auditor to notify the SEC upon certain events;
- require private fund RIAs, in connection with an adviser-led secondary transaction, to distribute to investors a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider;
- prohibit all private fund investment advisers, including those that are not registered with the Commission, from engaging in certain activities and practices that the

[1] SIFMA AMG brings the asset management community together to provide views on policy matters and to create industry best practices. SIFMA AMG's members represent U.S. and multinational asset management firms whose combined global assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg.

[2] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 5955 (February 9, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-5955.pdf (the "**Release**").

Commission has deemed to be contrary to the public interest and the protection of investors; and

- prohibit all private fund investment advisers from providing certain types of preferential treatment that have a material negative effect on other investors, while also prohibiting all other types of preferential treatment unless disclosed to current and prospective investors.

Additionally, the SEC is proposing to require all RIAs, including those that do not advise private funds, to document the annual review of their compliance policies and procedures in writing.

We note that the Release is 341 pages long, proposes a range of significant changes to complicated securities laws and complex financial markets, asks the public to respond to approximately 943 questions, and provides only 32 days to respond during which we also are working on responding to several additional new rulemakings from the Commission.[3] In light of these facts, we and all other public commenters are limited in our ability to conduct a robust analysis of the proposed rule and provide meaningful feedback to the Commission (as is contemplated by the Administrative Procedure Act[4]), which we believe will harm the quality of the Commission's regulations and potentially lead to unintended consequences that have an adverse effect on America's capital markets.

Given this brief notice and comment period, we have had limited opportunity to meaningfully consider the potential unintended consequences of every aspect of the Proposed Rule or to quantify the costs and burdens it would impose. Nonetheless, based on our consideration to date, we have significant reservations concerning the Proposed Rule. As further described below, we believe that the Proposed Rule would harm investors by increasing the cost of accessing private funds, limit investors' ability to invest in funds that have generated strong returns and limit privately held companies' capital formation opportunities arising from private funds. Further, the Proposed Rule would impede competition in the fund industry by increasing the barriers to entry for new advisers and potentially result in the consolidation of smaller firms. Moreover, the Proposed Rule is overly broad in its scope, covering collateralized loan obligation issuers ("**CLOs**") and other types of investment vehicles that do not seem to fit within the Commission's stated concerns.

Our letter contains five sections. Part I provides a brief overview of the private funds industry (which we define to include private equity, venture capital, hedge funds, credit funds and other similar investment funds) and its unique role in our capital markets. Part II summarizes our concerns regarding the Commission's lack of statutory authority for most if not all of the aspects of the Proposed Rule. Part III discusses the Proposed Rule's proposed major shift in policy, which we believe is unwarranted. Part IV provides recommendations on altering the design of the Proposed Rule to make it more workable, and also discusses various potential impacts of the

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[3] *See* U.S. Securities and Exchange Commission, Rulemaking Index, *available at* https://www.sec.gov/rules/rulemaking-index.shtml.

[4] *See* Administrative Procedure Act, 5 U.S.C. § 553.

Proposed Rule that have not been addressed by the Commission. Part V provides more detailed comments regarding specific aspects of the Proposed Rule in its current form. We urge the Commission to consider our comments thoughtfully and with an open mind in order to ensure that the Commission fulfills its Congressional mandate to facilitate capital formation (rather than stifling competition and innovation).

I. INTRODUCTION AND BACKGROUND ON THE PRIVATE FUNDS INDUSTRY

Since the late 1970's, the alternative investment funds industry as an asset class has grown dramatically from its starting point as a niche market catering primarily to very wealthy families and individuals to its current status as a key component of a diversified, risk-managed investment portfolio for a wide range of investors including university endowments, benefit plans and retirement funds and non-U.S. institutional investors.

Private funds are designed to allow sophisticated investors to diversify their portfolios relative to conventional debt and equity investments and access opportunities with a goal of providing superior risk-adjusted returns. In essence, private funds represent an alternative to registered investment funds and investments in listed securities, whether made directly or through managed accounts, and can potentially offer more flexible and customized investment opportunities for sophisticated investors. Private funds are an important component of the capital markets. For example, hedge funds can help provide price discovery in public markets; private equity funds and venture capital funds can provide funding and management expertise to privately held companies and start-ups that often could not scale their operations or pivot from financial stress using other available means of capital. CLOs, which generally are viewed as interest-paying investment vehicles that are collateralized with a pool predominantly consisting of loans, can help provide stable, consistent investment returns on which insurance companies and other institutional investors rely to meet their investment needs (or manage liabilities) while also providing important debt funding for companies of all shapes and sizes. In short, private funds can fill a variety of different roles in the market, tailored to meet the needs of their investors, as well as the issuers in which they invest and the capital markets at large.

The growth of the private funds industry over the past several decades is itself a testament to the benefits offered to sophisticated investors since that growth has been fueled in large part by investors seeking access to the asset classes, investment structures, and flexibility of private funds and to the freedom to negotiate investment terms that the private funds industry has provided. The continued success of the industry remains entirely dependent on the continued, active participation of these sophisticated investors. It is not in the interest of the industry to harm or significantly circumscribe the flexibility enjoyed by these investors; rather, industry participants seek to benefit alongside them. Indeed, many SIFMA AMG members are themselves investors in other private funds through funds of funds that they sponsor.

In our view, the record of negotiated evolution of contractual terms over time through robust, fund-by-fund interactions between investors qualified under long-standing Commission exemptions and interpretations to invest in private funds on the one hand, and the sponsors and advisers to private funds on the other hand, comprise the driving force behind the evolution, growth and success of the industry. That flexibility has created the innovation that is a hallmark of our industry, and which we believe will be significantly hampered by the Proposed Rule.

We highlight the dynamism and ongoing process of negotiated evolution at the outset because elements of the Proposed Rule, taken together, represent a radical departure from the prudent regulatory and market-driven oversight approach that has historically guided the private funds industry, and the investment advisory business more generally. Instead, the Proposed Rule would move away from a well-established, disclosure-based model that seeks informed consent from financially sophisticated individuals and institutional investors towards a substantially prescriptive regulatory approach more commonly utilized for registered investment companies (whose framework primarily focuses on the protection of those funds' retail, "main street" investors), with a result that is, in some cases, even more stringent than the requirements applicable to such registered funds. Adopting, implementing and administering the Proposed Rule would divert the Commission's limited enforcement and examination resources from protecting retail investors to protecting highly sophisticated and wealthy investors.[5] In our view, the Commission should remain focused on its statutory mission of protecting retail investors who invest in retail products, rather than the private funds that are the focus of the Proposed Rule.

It is important to note that nearly all of the enforcement actions cited by the Commission in support of the Proposed Rule involved specific allegations of a failure in the process of disclosure and consent of individual fund advisers, rather than evidence of a systemic problem in the industry. The relationship between those enforcement cases and a number of requirements under the Proposed Rule that would ban long-standing industry practices appears to be an example of a solution in search of a problem. We believe that Commission enforcement actions against investment advisers who fail to adhere to existing rules and regulations is the appropriate regulatory tool (rather than the imposition of prescriptive rules), and that the history of enforcement actions successfully brought by the Commission serves to demonstrate that the current regulatory requirements are being effectively and vigorously enforced—not that the Commission lacks the tools necessary to bring action against offenders.

We set out below more detailed comments keyed to particular items of the Proposed Rule. We also urge the Commission to reflect on the overarching perspective that we have described. A prudent and effective approach to reform must proceed deliberately and with care to avoid damaging the attributes that have led legions of sophisticated investors to choose to join or to increase their participation in the private funds industry.

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[5] *See* Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking, Commissioner Hester M. Peirce (Feb. 9, 2022), *available at* https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922.

II. THE COMMISSION LACKS AUTHORITY TO PROMULGATE THE PROPOSED RULE AND HAS PROVIDED AN INSUFFICIENT JUSTIFICATION FOR THE PROPOSED RULE

A. The SEC lacks statutory authority to promulgate the Proposed Rule

The Release cites[6] four provisions of the Advisers Act as providing authority for the Proposed Rule, but none of them gives the Commission power to enact the unprecedented and sweeping regulation of advisers to private funds contemplated in the Proposed Rule. In fact, one cited provision does not give the Commission any rulemaking authority at all.[7] A second provision does not give the Commission independent rulemaking authority; it only permits the Commission to make rules tied to the "functions and powers conferred upon the Commission *elsewhere*" in the Advisers Act.[8] The remaining two provisions cited in the Release give the Commission some rulemaking authority, but they do not provide the broad authority that would be needed to enact the Proposed Rule.[9]

For example, the rulemaking provisions do not give the Commission the power to enact blanket prohibitions on certain activities of investment advisers and side letter arrangements with investors.[10] Those prohibitions do not target "fraudulent, deceptive, or manipulative" business practices.[11] Instead, they prevent sophisticated investors from entering into contracts with advisers that contain terms that the Commission believes to be commercially disadvantageous to certain investors. Further, the Commission does not have the power to prohibit any and all adviser practices that it deems to be "contrary to the public interest and the protection of investors."[12] Congress did not intend to give the Commission unbounded power to regulate private fund advisers or to limit the ability of investors to negotiate for terms that they and advisers believe are prudent.

In addition, the Proposed Rule goes well beyond the limits on investment advisory contracts set out in the Advisers Act. Section 205 of the Advisers Act contains the only statutory limitations on investment advisory contracts. That provision gives the Commission only narrow rulemaking authority to place additional limits on advisory contracts. Section 205(a) lists several requirements of an advisory contract between an adviser and a client. A contract may not compensate an adviser based on a share of capital gains upon the client's funds or authorize the adviser to assign the contract without the client's consent, and a contract must require that an adviser organized as a partnership notify the client of any change in membership within a reasonable time. Section 205 does not otherwise limit an adviser's ability to negotiate, enter into, or perform an advisory contract. Sections 205(e) and (f) then give the Commission the power to promulgate certain rules with respect to advisory contracts. They specify that the Commission may issue rules that exempt persons or transactions from the prohibition on compensation as a

[6] Release at 325-26.
[7] 15 U.S.C. § 80b-3(d).
[8] *Id.* § 80b-11(a) (emphasis added)
[9] *Id.* §§ 80b-6(4), 80b-11(h).
[10] Release at 339-341.
[11] *Id.* § 80b-6(4).
[12] *Id.* § 80b-11(h)(2).

share of capital gains, and rules that prohibit or limit the use of arbitration clauses in advisory contracts. But that is the only power Congress gave the Commission with respect to limiting investment advisory contracts.

The Proposed Rule would restrict advisory contracts far beyond what Congress allowed in Section 205. For example, proposed rule 211(h)(2)-1 would prohibit advisory contracts that, among other things, charge the private fund for fees or expenses related to a government examination or investigation, reduce the amount of any general partner clawback by actual, potential or hypothetical taxes, allow an adviser to borrow from a private fund client, and indemnify an adviser for willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund. Those prohibitions are unrelated to either the enumerated requirements in Section 205(a) or the limited areas of additional Commission rulemaking authority with respect to advisory contracts under Sections 205(e) and (f). Congress did not intend to give the Commission unlimited authority to regulate advisory contracts.[13]

B. The Proposed Rule is impermissibly retroactive

An administrative agency cannot enact rules with retroactive effect unless Congress gives the agency the power to do so in clear and unmistakable terms.[14] Here, none of the statutory provisions on which the Commission relies[15] expressly grants it the power to promulgate retroactive rules.[16] The Proposed Rule plainly would have a significant retroactive effect. Many advisers have existing contracts with funds and investors that cover fees and expenses, clawbacks, the ability to borrow, limitations on liability and other terms impacted by the Proposed Rule. The Proposed Rule would prohibit advisers from fulfilling those contractual obligations,[17] would impose material costs to implement, and would interfere with many advisers' rights with respect to the existing funds that they manage.

For example, the Proposed Rule would prohibit advisers to private funds, even with full disclosure to investors, from: (i) charging private funds for fees or expenses associated with a government examination or investigation of the adviser, or for any regulatory or compliance fees and expenses of the adviser; (ii) reducing the amount of any general partner clawback by actual, potential or hypothetical taxes; (iii) borrowing private fund assets from a private fund client; and (iv) seeking indemnification by the private fund for willful misfeasance, bad faith, negligence, or recklessness in providing services to the fund.[18] Nearly all private fund governing documents contain clauses that address the foregoing issues, and the Proposed Rule would bar contract clauses which appear in nearly every private fund contract. The Proposed Rule also would prohibit

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[13] For these same reasons, we believe that the Commission would lack the statutory authority to establish maximum fees that advisers may charge at the fund level, to prohibit the "2 and 20" model, to prohibit advisers from receiving compensation from portfolio investments to the extent they also receive management fees from the fund, to prohibit management fees from being charged as a percentage of committed capital or to prohibit other "expense practices or arrangements." *See* Release at 23. Nonetheless, we note that we strongly oppose any such prohibitions.
[14] *Fernandez-Vargas v. Gonzales*, 548 U.S. 30, 38 (2006).
[15] Release at 325-26.
[16] *See* 15 U.S.C. §§ 80b-3(d), 80b-6(4), 80b-11(a), (h).
[17] Release at 340-341.
[18] Release at 339-340.

advisers from granting investors the ability to redeem interests on terms the adviser reasonably expects to have a material, negative effect on other investors.[19] Many multi-class funds are purposefully structured in a way to allow investors to make a commercial trade-off between liquidity and fees (or other terms), with different classes having different frequency of redemption dates, lock-up period, notice requirements, or other terms related to redemptions and liquidity. These distinctions between fund classes are material terms of the fund's governing documents and other contracts, which the fund's adviser is required to give effect to, but which could run afoul of the Proposed Rule. The foregoing examples illustrate how the proposed prohibitions on advisers would have retroactive effect. The Proposed Rule reflects the policy goal of precluding advisers from entering into contracts with those types of terms with their private fund clients, but does not account for the impact on pre-existing contracts such as fund governing documents, which the Commission acknowledges contain provisions that would be impermissible under the Proposed Rule.[20]

The Proposed Rule also would have a retroactive impact on side letter agreements that many (if not most) advisers have negotiated with sophisticated institutional investors in private funds. Those side letters grant investors access to fund information or the ability to redeem interests on specified terms. The scope of those side letter terms has been disclosed to other investors, who are on notice that the adviser may grant certain investors preferential terms. Similarly, fund investors typically receive extensive disclosures regarding, and the underlying private fund constituent documents that contain, the types of expenses that investors will bear and an adviser's standard of liability. Those disclosures regarding side letters, expense practices and limitations on liability have developed over time in response to Commission rules, interpretations and enforcement cases as well as staff guidance. Advisers to private funds have relied on those prior formal and informal statements in structuring private funds, negotiating with investors (whether in fund governing documents or side letters) and developing policies and procedures to enable them to monitor and comply with contractual provisions.

Significantly, the Release acknowledges the Proposed Rule's retroactive effects, because it notes that compliance will require advisers to modify their existing contracts. The Release repeatedly states that advisers will need to "re-negotiate, re-structure and/or revise certain existing deals or existing economic arrangements in response to" the proposed prohibitions.[21] Yet Congress never gave the Commission the authority to issue retroactive rules that interfere with advisers' (and investors') rights and duties under existing contracts. Further, there are many funds for which amendment of contracts to incorporate new terms based on the Proposed Rule may not be possible or may be impracticable. In many CLOs, for example, amendments to the CLO's management agreement require consent of majorities of both the most senior class of debt and of the equity; either or both classes may object to changes to the management agreement. Changes to CLO indentures may require noteholder consent as well.

The private funds industry has been in existence for well over five decades, and certain asset classes such as buyout private equity funds can have a term of existence for as long as 12-15

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[19] Release at 340-341.
[20] Release at 140-151 and 238-39.
[21] Release at 238-239, 241, 243, 247, 248.

years. According to the Commission's own data cited in the Release, over 68,000 private funds are in existence as of the date of the Proposed Rule. That means that the Proposed Rule, if adopted without eliminating its retroactive reach, has the potential to affect the existing contracts of all of those private funds and the approximately $22 trillion in assets they invest on behalf of investors.

In addition to being impermissibly retroactive, the Proposed Rule does not provide sufficient time for private funds to conform to the requirements of the rule, and the Release grossly underestimates the cost of retroactive compliance for both advisers and investors. The proposed one-year conformance period does not provide sufficient time to make required changes, and the compressed timeframe will also likely lead to increased costs and expenses for private fund advisers not adequately captured in the Commission's cost/benefit analysis.[22] The Commission also ignores the significant costs for investors who invest in private funds. Based on initial review, our members have serious concerns that many if not most of their fund governing agreements may *not* be unilaterally amended by the adviser (and side letters in almost all cases may not be so unilaterally amended), which means that each adviser to a private fund, *on a fund-by-fund basis*, will be required to renegotiate existing side letters and/or fund governing documents with investors in order to receive required amendment approvals by the end of the proposed one-year conformance period.[23] Beyond the costs of compliance, we expect that there will arise significant complexity in interpreting and applying the final rules, if they are adopted as proposed without significant modification.

We urge the Commission to take into consideration the potential impacts on existing private funds and their investors, and to provide for (i) a grandfathering of all private fund contracts in existence (including fund governing documents, advisory agreements, and side letters)[24] and (ii) an extended conformance period at least as commercially reasonable as was adopted for the 2020 modernization amendments to the Advisers Act's marketing rule (Rule 206(4)-1) (the "**Marketing Rule**").[25]

[22] Initial analysis by member firms suggests that *for each existing fund*, members expect legal costs in the range of approximately $45,000 to $60,000. These estimates relate solely to analyzing the governing documents and implementing the amendment consent process for *a limited number of straightforward changes*. This cost does not account for the additional significant costs to negotiate and amend side letters (which will be borne by both sponsors and investors) and is expected to be materially higher if numerous, or complicated changes, are required with respect to any fund as a result of the Proposed Rule. Initial member analysis indicates significant variation in side letters per fund, ranging from approximately 5 letters per fund on the low end, to more than 65 per fund on the upper end, which would add significant additional costs.

[23] In fact, certain aspects of the Proposed Rule, such as the prohibition on reducing an adviser's clawback by actual, potential, or hypothetical taxes (see Section V.A.2 below for additional discussion), will entail significant restructuring of fund economics and waterfall provisions, which require new negotiations between advisers and investors.

[24] In particular, we suggest that the rules should not apply to any private fund that has begun formally soliciting investors prior to the effective date of the rule (which would be evidenced by having made delivery of a definitive private placement memorandum, offering memorandum or other offering document to a prospective investor that is not a related person of the fund's adviser).

[25] We also suggest that additional conformance periods should be provided for exempt reporting advisers and other exempt advisers that transition to full registration with the Commission. In particular, we suggest that at a minimum, the quarterly statement requirements in proposed rule 211(h)(1)-2 would begin to apply at the start of the first calendar year after the exempt reporting adviser or exempt adviser has transitioned to registration as an investment adviser, with the reporting period for information required to be included in the quarterly statement not required to extend back

C. One provision in the Proposed Rule is foreclosed by the Advisers Act

Section 206(3) of the Advisers Act prohibits an adviser from purchasing securities from a client only when certain conditions are not met, namely, when the adviser has failed to "disclos[e] to such client in writing before the completion of such transaction the capacity in which he is acting and obtain[] the consent of the client to such transaction."[26] The Proposed Rule goes much further. It seeks to entirely prohibit advisers from borrowing "money, securities, or other private funds assets, or receiv[ing] a loan or an extension of credit, from a private fund client."[27] Prohibiting advisers from borrowing securities from clients would be inconsistent with Section 206(3) because Congress intended to place conditions on that practice – not to prohibit it altogether.

The Proposed Rule does not escape the requirements in Section 206(3) just because it refers to "borrowing" securities rather than "purchasing" them. Borrowing securities can involve a purchase. Under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") and the Advisers Act, borrowings and other extensions of credit could involve the issuance of a "note," whereby the resulting financing transaction is treated as the "sale" of a security.[28] As a result, an adviser seeking to enter into such a borrowing arrangement with a client would comply with Section 206(3) by obtaining the client's consent. Indeed, in recent cases the Commission has endorsed the view that those types of borrowing arrangements must comply with Section 206(3).[29] Prohibiting advisers from "borrowing" from clients as proposed, rather than continuing to require compliance with the requirements of Section 206(3), would contravene the regulatory scheme set out in Section 206(3). See Section V.A.5 below.

D. The Commission has provided an insufficient explanation for the Proposed Rule

The justification provided by the Commission for the Proposed Rule is lacking in three aspects. First, the Proposed Rule does not consider important consequences of the rulemaking. Second, the explanations provided for in the Release run counter to the evidence. Third, certain

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further than the date of the adviser's registration with the Commission. We believe this is in the spirit of the approach taken with respect to performance fees for newly registered advisers. *See* Advisers Act Rule 205-3(c)(2).

[26] 15 U.S.C. § 80b-6(3).

[27] Release at 339.

[28] Under Section 2(a)(36) of the Investment Company Act, the definition of "security" includes (among other things) any "note" as well as any "investment contract." Section 2(a)(18) of the Advisers Act, which includes a substantially similar definition of "security" also includes any "note" and any "investment contract" within such definition. *See also* SEC's Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992) at 66 (stating that "[i]n the context of the Investment Company Act, the financial instruments held by the issuers in structured financings generally have been considered to be securities").

[29] *In re* Clean Energy Capital, LLC and Scott A. Brittenham, Advisers Act Release No. 3785 (Feb. 25, 2014). *See also* Complaint, SEC v. Falcone, No. 12-CV-5027 (S.D.N.Y June 27, 2013); Complaint, SEC v. Harbinger Capital Partners LLC, No. 12-CV-5028 (S.D.N.Y June 27, 2012) and *In re* Lone Star Value Management LLC and Jeffrey Eberwein, Advisers Act Release No. 5448 (Feb. 24, 2020). Additionally, even if a financing transaction involved other private fund "assets" (that are not securities), recent Commission cases and interpretative guidance have concluded that client consent should be obtained if there is a highly conflicted transaction between a client and an adviser. *See In re* Fenway Partners, LLC, Peter Lamm, William Gregory Smart, Timothy Mayhew, Jr., and Walter Wiacek, CPA, Advisers Act Release No. 4253 (Nov. 3, 2015), and *In re* Naya Ventures, LLC, Dayakar Puskoor, and Prabhakar Reddy, Adviser Act Release No. 5461 (March 12, 2020). *See also* prior Commission statements in Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019).

explanations provided in the Release are not plausible. Each of those deficiencies are discussed in detail below in Sections IV and V.

III. THE PROPOSED RULE WOULD HARM INVESTORS AND UNDERMINE COMPETITION IN THE PRIVATE FUNDS INDUSTRY

A. The Proposed Rule Represents a Paradigm Shift in Policy

The Proposed Rule reflects a dramatic shift from longstanding Commission policies without accounting for the regulated community's "serious reliance interests" on those policies.[30]

The alternative funds industry has successfully returned capital to investors in part because the Advisers Act regime takes a principles-based approach to regulation that permits, and indeed promotes, the ability of parties to negotiate commercial arrangements as long as they do so in a manner consistent with an adviser's fiduciary duty, which imposes significant disclosure obligations on advisers.[31] The Proposed Rule represents a paradigm shift from the Commission's historical approach that could impede further capital formation for alternative funds and the investors that rely on those funds for returns. Pursuant to Section 202(c) of the Advisers Act, in connection with any rulemaking, the SEC is required to consider or determine not only whether an action is necessary or appropriate in the public interest, but also must "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." As further explained below, we believe that the Proposed Rule pivots from the Advisers Act's historical principles-based disclosure approach and undermines the goals set forth under Section 202(c).

B. The Advisers Act Historically has been a Disclosure-Based Regime

The Proposed Rule would upend over 80 years of precedent and federal case law treating the Advisers Act as a principally disclosure-based regulatory regime enforced through the Advisers Act's establishment of a federal fiduciary duty for investment advisers.[32] The Commission,[33] its staff[34] and certain notable federal court decisions have previously characterized the Advisers Act as a disclosure statute that relies on a principles-based regulatory approach.[35] In

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[30] *Dep't of Homeland Sec. v. Regents of the Univ. of Cali.*, 140 S. Ct. 1891, 1913 (2020) (quoting *Encino Motorcars, LLC v. Navarro*, 579 U.S. 211, 222 (2016)).

[31] See discussion in Section III.B., *infra*.

[32] *See SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180, 194 (1963) ("**SEC v. Capital Gains**").

[33] Registration under the Advisers Act of Certain Hedge Funds, Advisers Act Release No. 2333 (Dec. 2, 2004), 69 FR 72054 at 72080 (the "**2004 Hedge Fund Advisers Adopting Release**").

[34] Keynote Address to the International Conference on Private Investment Funds by Andrew J. Donohue, Former Director of the SEC's Division of Investment Management (March 10, 2008), *available at* https://www.sec.gov/news/speech/2008/spch031008ajd.htm.

"The approach we have taken in the United States to regulating investment advisers resembles in many respects the principles-based approach to regulation here. When enacting the Investment Advisers Act of 1940, Congress recognized the diversity of advisory relationships and through a principles-based statute provided them great flexibility, with the overriding obligation of fiduciary responsibility. Congress chose not to subject registered advisers to a 'fit and proper' test."

[35] *See also* Barry P. Barbash and Jasy Massari, *The Investment Advisers Act of 1940: Regulation by Accretion*, 39 Rutgers Law Journal 627 at 627-628 (2008).

the oft-cited case affirming an investment adviser's fiduciary duty under the Advisers Act (*SEC v. Capital Gains*), the U.S. Supreme Court stated that "the evident purpose of the Investment Advisers Act of 1940 [is] to substitute a philosophy of *disclosure* for the philosophy of caveat emptor" (*emphasis added*).[36] The Commission itself previously alluded to this view in a prior (but later rescinded) rule adoption requiring hedge fund advisers to register as investment advisers. As part of its argument that the relevant adviser registration requirement would not impede hedge funds' operations, the SEC stated within the adopting release's cost analysis that "[t]he [Advisers] Act does not prohibit any particular investment strategies, nor does it require specific investments" and that "[i]nstead of imposing specific procedures on registrants, the Advisers Act is *principally a disclosure statute* that requires registrants to inform clients fully of conflicts so that those clients can determine whether to give their consent" (*emphasis added*).[37] The SEC's long-standing disclosure principles-based framework stands in contrast to the Advisers Act's companion statute, the Investment Company Act, which adopts a more prescriptive rules-based approach in regulating investment companies.

The Proposed Rule also comes a little less than three years after the Commission's interpretive release regarding an investment adviser's fiduciary duty (the "**2019 Fiduciary Interpretation**"),[38] which it interpreted as comprising a duty of care and a duty of loyalty that taken together require an investment adviser to act in the "best interest" of its clients at all times.[39] The 2019 Fiduciary Interpretation reinforced that an investment adviser's duty of loyalty requires it to "eliminate ***or*** make full and fair disclosure" of all conflicts of interest that might incline an investment adviser to render advice that is not disinterested such that a client can provide informed consent to the conflict (emphasis added).[40] It also noted that advisers are not required to make an affirmative determination that a particular client understood the disclosure and that the client's consent to the conflict of interest was informed, but that disclosure should be designed to put a client in a position to be able to understand and provide informed consent to the conflict of interest (which could be either explicit or, depending on the facts and circumstances, implicit).[41]

The promulgation of the 2019 Fiduciary Interpretation re-affirmed that the historical practice of obtaining a client's informed consent through an investment adviser's full and fair disclosure of all material facts related to the advisory relationship is an effective and permissible means of curing an investment adviser's material conflicts of interest relative to its clients. It also stated that the method and extent of disclosure is based upon the facts and circumstances relative to the client, and that full and fair disclosure for an institutional client can differ (in some cases,

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[36] *See* SEC v. Capital Gains at 199. *See also Goldstein v. SEC* 451 F.3d 873, 876 (D.C. Cir. 2006) ("**SEC v. Goldstein**") (citing SEC v. Capital Gains and noting that "the Advisers Act is mainly a registration and anti-fraud statute").
[37] 2004 Hedge Fund Advisers Adopting Release at 72080.
[38] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019).
[39] *Id.* at 8 and fn. 23 (citing Amendments to Form ADV, Investment Advisers Release No. 3060 (July 28, 2010)).
[40] 2019 Fiduciary Interpretation at 8.
[41] 2019 Fiduciary Interpretation at 27.

significantly) from full and fair disclosure to retail clients, as institutional clients have a greater capacity and more resources to analyze and understand complex conflicts and their ramifications.[42]

Thus, instead of relying upon a prescriptive approach to curb abusive and fraudulent behaviors (an approach generally taken with respect to registered funds under the Investment Company Act), the Advisers Act traditionally has adopted a principles-based approach requiring investment advisers to act in a client's best interest, which includes an obligation to provide full and fair disclosure of material facts. The SEC has most recently reaffirmed that approach in the Marketing Rule, which (among other things) replaced the prior advertising rule's "broadly drawn limitations" with "principles-based provisions" designed to accommodate the continual evolution and interplay of technology and investment advice in the context of adviser advertising and marketing.[43] We believe that a principles-based rulemaking approach that gives flexibility to advisers to comply with principles is more complimentary to the Commission's dual mission of protecting investors, while at the same time contributing to fair, orderly, and efficient markets and the facilitation of capital formation.

The Proposed Rule's prescriptive approach of prohibiting certain practices irrespective of an adviser providing full and fair disclosure to advisory clients and their investors (whether sophisticated or not) seems to reject the notion that informed consent could ever suffice with respect to certain conduct. Under the Proposed Rule, the Commission appears to have taken the position that those practices present unsurmountable conflicts of interests that would be *per se* prohibited under the Advisers Act, even with respect to private funds that are offered and sold to institutional investors and high net worth individuals who have the financial sophistication and resources to understand fully disclosed conflicts (and make informed investment decisions) with respect to such funds. The Proposed Rule stands in stark contrast with the Commission's approach in the 2019 Fiduciary Interpretation, which provided examples of how advisers could satisfy their fiduciary duty by providing full and fair disclosure of material facts of the advisory relationship instead of prohibiting specific practices and conduct that could never be cured by informed consent.[44] As a result, we do not believe the Commission has provided a rational basis for reversing the longstanding approach, as set out most recently in the 2019 Fiduciary Interpretation.

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[42] 2019 Fiduciary Interpretation at 25-26.

[43] *See* SEC Press Release: SEC Adopts Modernized Marketing Rule for Investment Advisers (Dec. 22, 2020), *available at* https://www.sec.gov/news/press-release/2020-334, Investment Adviser Marketing, Advisers Act Release No. 5653 (Dec. 22, 2020) at 6 (the "**Marketing Rule Adopting Release**"). While the Commission did impose tailored requirements for certain types of performance advertisements, it did provide flexibility to advisers with respect to compliance with certain of these requirements. For example, the Marketing Rule permits the use of hypothetical performance provided the registered investment adviser has implemented policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience. The Commission noted that the adopted rule does not prescribe the ways in which an registered investment adviser may seek to satisfy this requirement but instead gives advisers the flexibility to develop policies and procedures that best suit their investor base and operations. Marketing Rule Adopting Release at 218-219.

[44] The original proposed version of the 2019 Fiduciary Interpretation included a statement that inferring or accepting client consent to a conflict of interest would not be consistent with the fiduciary duty where the material facts concerning the conflict could not be fully and fairly disclosed. Certain comment letters noted that this general statement suggested that the SEC believed that there could be certain conflicts of interest in which material facts could not be fully and fairly disclosed to clients. In the final, adopted version of the 2019 Fiduciary Interpretation, the SEC

C. Sophisticated Parties Should have Flexibility to Negotiate the Investment Structures that Best Serve their Needs and Objectives

As we discussed in Section I above, one of the defining characteristics of the private funds industry is the fact that individual funds can be designed to pursue a bespoke investment strategy based upon a package of economic and other contractual terms supportive of substantial alignment of interests between the fund's adviser and its investors. Although not a *universal* feature, a performance-based compensation model for an adviser represents one of the defining commercial arrangements in the private funds industry.[45] Another defining characteristic of the private funds sector has been the decades-long record of negotiated give and take over private fund terms and the undeniable success investors have had in altering fundamental terms when consensus among major portions of investors has been reached on the need for particular changes. By way of example, prior to the late 1980's, most venture capital, leveraged buyout and similar private funds did not net gains and losses from different portfolio investments. An institutional investor consensus coalesced around the concept of "netting" to temper the adviser's incentives linked to performance-based compensation (typically, the 20% carried interest) with investors' sensitivity to risk. As netting began to spread among the relevant private funds, it then became necessary to address the timing of incentive compensation when separate portfolio investments were sold. The generally agreed resolution on the timing questions produced in the United States a transaction-by-transaction distribution formula coupled with a clawback in the event that gains were followed by losses. Other major changes to fundamental economic terms include the requirement to pay out a "preferred return" to investors as a condition to incentive compensation and the use of management fee offsets to address certain payments from portfolio companies to advisers and their affiliates.

In addition to our concerns noted above regarding the potential for broad retroactive effect, we believe that the Proposed Rule would also diminish the ability of advisers and investors to negotiate the terms of their contractual arrangements. That unwarranted approach would impair the industry's past reliance on Commission rules and federal case law regarding practices that allow and enable an adviser to comply with its federal fiduciary duty to investors. According to Preqin, 57% of investors have decided not to invest in a fund because of terms and conditions,[46] which in our view is evidence of an active (and proactive) investor base. We are generally supportive of aspects of the Proposed Rule that will enhance transparency and further strengthen the historically crucial role of adviser-investor negotiations in shaping not only terms of individual funds but the private fund industry as a whole.

replaced that general statement and instead provided more specific examples of how advisers can make such full and fair disclosure. 2019 Fiduciary Interpretation at 27-28 and fn. 69.

[45] Notably, of course, some types of funds and strategies, such as "core" real estate funds and certain "funds-of-funds" often do *not* utilize performance-based compensation based on the return profile and the expectations of the funds' investors. We again note that it is this very commercial flexibility that has allowed private fund sponsors and investors alike to find the best arrangements that work for all involved.

[46] The 2021 Preqin Private Capital Terms Advisor.

D. Non-U.S. Advisers

The Commission has confirmed its long-standing position that the substantive provisions of the Advisers Act would not apply to the dealings of a non-U.S. investment adviser to its non-U.S. clients; this position is further reflected in various Commission and staff guidance regarding the interaction of U.S. advisers and their non-U.S. affiliates (and whether or when such affiliates would be subject to Advisers Act requirements).[47] We agree with this approach and support the Commission's position on this question. Many advisers have designed their policies and procedures to comply with the Commission's prior guidance on this point, and such long-standing arrangements should be permitted to continue without disruption.[48]

IV. BROAD ALTERATIONS TO THE DESIGN OF THE PROPOSED RULE

Although it cites enforcement cases involving particular adviser practices of hedge fund and private equity fund advisers, the Proposed Rule would also affect advisers to funds of funds, credit funds, infrastructure funds and commodity pools, as well as structured products such as CLOs. Those types of investment vehicles are a subset of "private funds" that possess characteristics and operate differently from a typical buyout private equity fund, where an adviser controls (or has a controlling influence over) the underlying portfolio companies. Moreover, the Proposed Rule would affect standalone investment advisory firms differently than advisers affiliated with (but operating independently of) larger financial services firms due to the breadth of the Proposed Rule. As a result, compliance with various aspects of the Proposed Rule (such as the requirements related to adviser-led secondaries, mandatory annual audits and reporting) would not result in meaningful or informative disclosures or would impose costs that are not commensurate with potential benefits.

An important feature of the private funds industry is the fact that barriers to entry for private fund advisers, especially those exempt from registration with the Commission, are relatively low compared to most other investment management service providers, a feature that has allowed for a constant stream of new entrants and robust competition. The proposed prohibitions, operational requirements and associated administrative and compliance costs with respect to the Proposed Rule may likely prove significant to smaller, start-up and emerging private fund advisers, who may decide to exit or forgo entering into the private fund space, resulting in less investor choice, diversity and competition within the industry.

Given these and our other concerns discussed in Sections I through III above, we generally urge the Commission to modify the overall scope of the Proposed Rule to: (i) replace the proposed definitions of illiquid fund and liquid fund with existing Commission definitions, (ii) exclude specifically from the definition of "private fund" certain types of entities, (iii) narrow the definition

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[47] *See, e.g.,* ABA Subcommittee on Private Investment Entities, SEC Staff No-Action Letter (August 10, 2006), ABA Subcommittee on Private Investment Entities, SEC Staff No-Action Letter (Dec. 8, 2005).

[48] *See* Uniao de Bancos de Brasileiros S.A., SEC Staff No-Action Letter (Jul. 28, 1992); Mercury Asset Management plc, SEC Staff No-Action Letter (Apr. 16, 1993); Kleinwort Benson Investment Management Limited, SEC Staff No-Action Letter (Dec. 15, 1993); Murray Johnstone Holdings Limited, SEC Staff No-Action Letter (Oct. 7, 1994); ABN AMRO Bank, N.V., SEC Staff No-Action Letter (Jul. 7, 1997); and Royal Bank of Canada, SEC Staff No-Action Letter (Jun. 3, 1998).

of "related persons," (iv) exclude certain portfolio investments from the definition of "covered portfolio investment," (v) permit properly disclosed, existing approval mechanisms to address any potential conflicts that arise regarding an adviser or its related persons, and (vi) exclude certain advisory relationships.

We also have a number of specific concerns with many aspects of the Proposed Rule, which are discussed in Section V below.

A. Replace Illiquid Fund and Liquid Fund with existing SEC definitions

The Proposed Rule introduces new definitions of "illiquid fund" and "liquid fund" within its proposed quarterly statements requirement rather than relying on existing definitions of various types of private funds in Item 7.B.1 of Form ADV and Form PF. The relevant sections of Form ADV and Form PF already have an extensive set of definitions with respect to private funds, which are used consistently in both forms.[49] The addition of two new regulatory terms, which seek to further consolidate the categorization of private funds into two narrow categories solely for quarterly performance reporting purposes, does not take into consideration the various types of private funds that exist in the industry, and the Release does not provide a sufficient justification for these terms given the overly broad scope and the ambiguity of the terms that are used. For example, securitized asset funds (such as CLOs) have features or structures that largely distinguish them from the types of private funds directly addressed in the Commission's discussion of the Proposed Rule; accordingly, it is unclear whether such funds should be viewed as "liquid" or "illiquid" within the construct of the Proposed Rule, and in any event what policy goal would be achieved by so designating such funds. Subjecting private funds to broad-based reporting requirements that fail to take into consideration the vast differences between them may add unnecessary complexity and burdens in a private fund adviser's attempt to comply fully with such requirements and not be misleading.[50]

This is in contrast to the approach taken in the original adoption of Form PF, which introduced seven categories of private funds and sought to tailor the reporting requirements in the Form based on the specified type of private fund.[51] Notably, the Commission stated that distinguishing among types of private funds was important for two reasons: (i) it limited the information collection burdens on advisers to private funds for which the information is most relevant, and (ii) separating reported data by fund strategy allows extraneous information to be excluded, which the Commission believed will improve its utility.[52] Use of the existing Form ADV and Form PF definitions would thus help the Commission better tailor any performance reporting requirements to the particular type of private fund, thereby potentially ameliorating any unnecessary compliance burdens undertaken by private funds and their advisers and improve the

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[49] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Advisers Act Release No. 3308 (October 31, 2011) ("**2011 Form PF Adopting Release**") at 23, fn. 67.

[50] In some cases, a private fund may hold both illiquid and liquid holdings, which may result in compliance challenges in trying to accurately identify a fund as either "liquid" or "illiquid" under the Proposed Rule. Additional guidance should also be provided with respect to how side pocket investments should be classified.

[51] 2011 Form PF Adopting Release.

[52] 2011 Form PF Adopting Release at 27.

utility of the performance reporting to private fund investors so that they correspond better with the types of performance metrics actually sought and utilized by investors in each category of private funds.

The introduction of the new regulatory terms that would only be used for complying with the quarterly performance reporting requirements under the Proposed Rule would likely lead to additional compliance burdens and costs for private fund advisers. Adopting new terms would require private funds to conduct an additional analysis and categorization of their private funds (on top of the existing categorization process for Form PF and Form ADV reporting purposes), which would need to be reviewed and potentially re-evaluated from time to time. Private fund advisers have already devoted significant time and resources to adapt to the private fund definitions already in use within Form ADV and Form PF for reporting purposes, so utilizing existing terms would reduce compliance burdens. Referencing existing regulatory terms would also be consistent with the Commission's approach in other rulemaking[53] as well as with other portions of the Proposed Rule. Notably, and with respect to the latter, other aspects of the Proposed Rule use particular Form ADV definitions with respect to certain reporting requirements, noting that advisers already have experience assessing those terms as part of their disclosure obligations on that form.[54]

B. Exclude certain private funds

The definition of a private fund (which was incorporated into the Advisers Act as a result of the amendments to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**")) is broad. Because of that far-reaching definition, the Proposed Rule fails to acknowledge that certain types of funds are not addressed in the Release but are nonetheless included in the definition of "private fund." The Release focuses on private equity and hedge funds and makes certain assumptions about the particular strategies of those funds – namely funds that invest in and control underlying portfolio companies. As we noted above, the private funds industry is diverse, and includes various types of investment strategies, including direct lending (funds that lend money to individuals as well as corporate entities), fund of funds (which invest in

[53] 2011 Form PF Adopting Release at 23 (conforming the Form ADV and Form PF private fund terms). *See also* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Release No. 3222 (June 22, 2011). In adopting the 20 percent basket for non-qualifying investments within the definition of "venture capital fund," the Commission analogized to, and enacted a consistent approach with, the Investment Company Act's names rule (Rule 35d-1), which states that an investment company name suggesting that it invests in certain investments is limited to investing no more than 20 percent of its assets in other types of investments (*i.e.*, non-qualifying investments). Although recognizing that the policy goals in both rules were different, the Commission noted that the tensions it sought to reconcile were similar. *Id.* at 18-19.

[54] Release at 29-30 and accompanying fns. 34 and 35 (utilizing the same definition of "related person" and "control" as those used in Form ADV with respect to the investment adviser compensation reporting requirements). We would further suggest that for these terms, in the final adoption the Commission should indicate that the staff's existing guidance and FAQs concerning interpretation of these terms should be applied to the terms as used in the Proposed Rule. For example, we note the first question and answer related to Item 7.A with respect to whether operating companies "controlled" by private fund clients should be reported as related persons (or advisory affiliates) for purposes of Item 7.A and Item 11 of Form ADV Part 1. *See* Form ADV and IARD Frequently Asked Questions, Form ADV: Item 7.A, *available at*: www.sec.gov/divisions/investment/iard/iardfaq.shtml. Such a statement by the Commission would help ensure that if and to the extent that guidance regarding these defined terms is updated for one purpose, it is applied uniformly in other circumstances where the same term is otherwise used.

other investment funds, each of which will have its own investment strategy and contractual obligations), and hedge funds that invest in the public markets as well as illiquid private assets.

Hedge funds that actively trade and invest in publicly traded equity securities or related instruments generally are not in a position to control or dictate the terms of how their portfolio companies conduct their businesses much less determine which "related persons" of the adviser that such companies can retain. Credit funds which originate loans to, or invest in loans issued by, corporate borrowers or consumers are similarly situated in that they hold debt investments and would not possess information (or necessarily be able to obtain information) regarding the types of transactions that these borrowers conduct. Even among private equity funds (which are cited in many examples in the Release), investment strategies are diverse and include many that do not entail "control" of their portfolio investments, including for example co-investment funds that invest in minority positions in companies alongside other investors, funds-of-funds that make private equity fund commitments but do not themselves pursue buyout transactions as well as funds that provide limited partners with liquidity by acquiring private equity interests on the secondary market (*i.e.*, secondaries funds). Given the breadth of the term private fund, we believe that the overall effect of the Proposed Rule would be to reduce offerings in the market to investors, due in part to the cost of compliance, and potentially impede capital formation.

Because the Proposed Rule treats all private funds alike without differentiating between them on the basis of risk profile, control over underlying assets or other characteristics, even assuming the concerns raised by the Commission are correct, the Proposed Rule is not appropriately tailored to identify (and hence define) the fund population that the Commission seeks to regulate. Given the breadth of the term private fund, we believe that the overall effect of the Proposed Rule would be to reduce offerings in the market to investors, due in part to the cost of compliance, and potentially impede capital formation. As such and as further discussed below, we urge the Commission to exclude certain private funds from the scope of the Proposed Rule.

1. Exclude CLOs

We urge the Commission to exclude any CLO that intends to operate principally in a manner consistent with the criteria discussed below from the definition of a private fund for purposes of the Proposed Rule (an "**Excluded CLO**").[55] For the reasons discussed in greater detail below, we believe that this approach would help to further tailor the scope of the Proposed Rule. We also believe that this approach would be consistent with the SEC and CFTC's adoption of the Volcker Rule, whereby certain types of funds (*e.g.*, loan securitizations and certain credit funds) were excluded from the definition of a "covered fund" for purposes of that rule.

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[55] In the alternative, and consistent with our recommendation to use existing defined terms when possible, we suggest that the Proposed Rule could simply exclude "securitized asset funds," as that term is defined in Form ADV and Form PF. We believe that term is well understood by industry participants and is narrowly tailored to focus on issuers of asset-backed securities. We note that in either event, provision should be made to allow the same treatment for CLOs in the "warehouse" or "ramp-up" phase, as well as those in the wind-down phase, which intend to operate, or have historically operated, essentially in the same manner as CLOs when debt instruments in the form of notes issued in the capital markets are outstanding.

The Commission fails to account for the fact that essentially all U.S.-managed CLOs rely on Section 3(c)(7) of the Investment Company Act in order to avoid registration as an investment company. In fact, as noted above, CLOs are not specifically discussed in the Release.[56] To qualify under Section 3(c)(7) of the Investment Company Act, investors (whether investing in debt or equity issued by a CLO) must be qualified purchasers. In reality, a large majority of U.S. third party investors in CLOs qualify as Qualified Institutional Buyers ("**QIBs**"), which means that they must have at least $100 million in securities portfolios. Moreover, CLOs are typically structured to be bankruptcy remote; have an independent trustee with authority over accounts and cash flows, including payment of expenses; after a warehouse period, issue tranches of notes and loans, the debt tranches of which are rated and monitored by one or more SEC-regulated rating agencies,[57] and have diversified portfolios of upwards of 250 to 500 or more positions in broadly traded corporate loans (and sometimes also corporate bonds, and, in some structures, consumer loans); moreover, the CLO managers and the CLOs typically do not have a controlling interest in any of the obligors in the portfolio.

We believe that any CLO that intends to operate principally in a manner consistent with the foregoing attributes should be treated as an Excluded CLO (and hence not a private fund under the Proposed Rule). We also note that the form and content of the periodic reporting provided by an independent collateral administrator to CLO investors has developed and standardized over a long period of time to meet the specific needs and requirements of CLO investors, which differ from those of traditional private fund investors.

2. Exclude SPVs

As the definition of "private fund" is driven by reliance on two commonly used exceptions from the definition of "investment company," the term includes many special purpose vehicles ("**SPVs**") used in investment structures to provide tax benefits to investors, to limit a fund's liability, to facilitate joint investments using aggregating entities, or for other *bona fide* purposes.

In addition, the application of the Proposed Rule to SPVs also appears to result in unintended consequences. As noted above, private funds and advisers routinely use SPVs in their structures to function as tax blockers, to limit liability, as holding companies for portfolio investments, to aggregate joint investments for multiple clients, and for other purposes. Indeed, registered investment companies ("**RICs**") also often make use of SPVs for commodities trading, for investing in Chinese companies, and otherwise. Because these SPVs hold securities, they typically need to rely on Section 3(c)(1) or (7) under the Investment Company Act, and accordingly are considered "private funds" in their own right. However, we believe that the application of the Proposed Rule to most SPVs is inconsistent with the policy goals of the Commission: it will substantially increase costs and result in investor confusion, rather than transparency. As we

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[56] The Release makes limited passing references to "securitized asset funds" in the Economic Analysis section mostly in recognition that they are reported as such on Form ADV.

[57] After a warehouse period, the capital structure for a CLO is always tranched and subject to detailed payment priority and subordination provisions. The capital structure always includes both debt and equity tranches. Some debt investors prefer to invest in the form of a loan rather than a note. CLOs sometimes redeem all of the rated debt by liquidation of the portfolio and end up with only CLO equity outstanding, but these cases represent just the wind-down of the CLO.

discuss in greater detail below, we do not believe that private fund investor interests will be well served by, for example, requiring each SPV held by the fund to distribute separate audited financial statements or quarterly reports; rather, we believe delivery of such statements and reports will likely lead to investor confusion, since they would expect to simply receive consolidated reports related to their investment in their fund. By the same token, we believe that RIC investors are adequately served by the existing reporting they receive as required under the Investment Company Act, and that requiring special reporting to RIC investors (to the extent the RIC is deemed to be in a control relationship with the RIC's adviser)—merely because their RIC happens to conduct some of its investment activity through an SPV that is a private fund—is unnecessary, unduly burdensome, and likely to lead to investor confusion. Similarly, separate account clients—particularly institutional clients—often negotiate detailed, customized reporting with advisers, and these additional reporting requirements would be triggered solely because a separate account invests through an SPV would not be intended or expected by either party.

Accordingly, and as further discussed in Section V.C.1 below, we urge the Commission to exclude SPVs that are, directly or indirectly, owned 99% or more[58] by (i) other private funds advised by the same investment adviser (or its related persons) and that *are* subject to the Proposed Rule, (ii) one or more RICs or business development companies regulated under the Investment Company Act that are advised by the same investment adviser (or its related persons), (iii) one or more other clients of the investment adviser (or its related persons) that meet the definition of a "qualified client" under Advisers Act Rule 205-3, or (iv) "knowledgeable employees" (as defined in Rule 3c-5 under the Investment Company Act) or related persons of the investment adviser.

C. Narrow the definition of "related person"

Many advisers are part of a larger financial services organization, which offer their respective clients and customers a variety of products and services. In reliance on pre-existing Commission and staff guidance, these institutions have adopted information barriers and similar protocols or procedures to help ensure that the operations of one business do not implicate another business from a legal, regulatory or compliance perspective. That structure is typical in the context of financial services firms with investment banking and capital markets services and also investment advisory services (*e.g.*, separation of "buy side" and "sell side" businesses). Moreover, when decisions to enter into financial transactions are made, they are made independently of other business lines. For example, a credit fund may be advised by an investment adviser affiliated with a large investment banking firm acting as underwriter to the same portfolio company (or its subsidiaries) in which the credit fund holds outstanding public debt.

As used in the Proposed Rule, the term "related person" would include "affiliated" parties that are under common control without any distinction, and even though commercial decisions are made independently, and without any consultation, of other affiliated parties. This could result in an adviser inadvertently failing to comply with the Proposed Rule, in part because information barriers preclude it from knowing in advance whether a "related person" has "borrowed" securities

[58] We note that in certain structures, for tax and other reasons, a *de minimis* interest in the SPV may need to be held by third parties.

from a private fund (as may occur in securities lending transactions, particularly if a third party agent has been retained to administer the securities lending program).

A fund that invests in third-party funds may not be able to obtain, or would incur additional costs to obtain, information from underlying funds in order to comply with the private fund quarterly account statements requirement under proposed rule 211(h)(1)-2, a cost which could not be borne by investors under proposed rule 211(h)(2)-1(a)(3). Similarly, a credit fund that lends money to corporate borrowers would need to re-negotiate its contracts with borrowers (likely on adverse terms) in order to obtain information regarding transactions with "related persons" notwithstanding that the adviser has no role in (or information regarding) the borrower's retention of affiliated service providers.

As defined, the term related person could also include other investment vehicles, pools or "private funds" that are controlled by the adviser, such as where the adviser acts as general partner, or where the adviser or its personnel hold 25% or more of the economic (but not voting) interest of the vehicle. Feeder funds and alternative investment vehicles typically comprise a fund complex, and expenses related to their operation are generally combined and re-allocated *pro rata* (except for specified expenses) so that no group of investors bears a disproportionate burden. Precluding advisers from charging a feeder fund for ordinary course master fund operating expenses—because the master fund technically fell within the definition of "related person" due to the control relationship with the adviser—would be in our view an unintended consequence of the use of the term related person in various prohibitions in the Proposed Rule (*e.g.*, proposed rule 211(h)(2)-1(a)(2) and (3)).

As a result, we believe that the term "related person" at a minimum should exclude (i) any affiliates that are operated independently of the adviser, (ii) any affiliates that are separated via information barriers or similar compliance policies and procedures, (iii) other private funds affiliated with the adviser or its related persons and (iv) any affiliates operating pursuant to the *Unibanco* line of no-action letters. We believe that this approach would more appropriately identify the types of transactions over which the adviser has the ability to control or influence a portfolio company's financial transactions that would give rise to the types of conflicts identified by the Commission in the Release.

D. Exclude certain portfolio investments from the definition of covered portfolio investments

We urge the Commission to confirm or clarify that "portfolio investment compensation" is not intended to include amounts paid by portfolio investments to an adviser or its related person that do not arise out of the private fund's investment or as a result of the control or influence conferred by such investment. Specifically, we request clarification that compensation will only be viewed as "attributable to" the private fund's investment where (i) the adviser (A) controls, or has material influence over, the portfolio investment's decision to hire, retain or fire related persons, or (B) is not recused or removed from decisions involving the hiring, retention or removal of related persons, or (ii) the retention of the adviser or related person is a condition of the private fund's investment in the portfolio investment.[59] We believe that these exclusions do not give rise to the same level of concerns regarding potential conflicts identified in the Release, for many of the same reasons discussed in Section IV.B above. In particular, the Release does not adequately distinguish between the types of situations involving portfolio investments that can create opportunities for conflicts versus those that do not.

Private funds invest in many different types of assets and use different investment strategies. A high frequency trading hedge fund invests in many different types of public company issuers and turnover can be exceedingly high in any given period. A typical corporate credit or structured credit fund invests in the debt issued by corporate or asset-backed issuers or borrowers, respectively, giving the fund only limited or no control or voting rights, which may only arise in the event of default or similar situations. A typical CLO holds a loan portfolio of 250 to 500 loans from corporate borrowers, where the loans are broadly syndicated and are widely traded. Secondary funds similarly acquire hundreds of non-controlling private equity commitments from selling limited partners seeking liquidity. Co-investment funds make dozens of direct minority investments in portfolio companies alongside third-party sponsors and do not typically control the underlying portfolio company. Funds-of funds also typically invest in third party funds without any level of control or influence beyond, at best, an advisory committee seat, and often without obtaining enhanced information rights. A venture capital fund or middle market private equity fund could take a less-than-controlling stake (*e.g.*, less than 25%) of an issuer's new equity or debt issuances.

In none of the above cases however does the adviser have the ability to influence the day-to-day business of the corporate entity/underlying fund, much less a decision by any corporate entity/underlying fund to retain a related person for services such as investment banking, consulting/advisory, property management, loan servicing, or financing services. This issue becomes more acute for large financial services firms with diverse business lines globally, where commercial relationships are addressed independently and without consultation of other business lines due to regulatory restrictions or internal policies.[60]

In other situations, even where they have board seats, advisers may be subject to information walls or other robust conflicts processes requiring recusal from potentially conflicted transactions. For example, if an adviser held a board seat on the board of a portfolio company, conflicts policies could require that an adviser recuse themselves from the decision making initially and on an on-going basis.[61] In these instances, we believe that the relevant portfolio investments

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[59] *See* further discussion in Section V.C.3 below.

[60] *See* further discussion in Section IV.C above.

[61] For comparison, Delaware law has a long established precedent of precluding a director from liability in an interested transaction if that interested director abstains completely from participating in the interested transaction. *See Weinberger v. UOP, Inc*., 457 A.2d 701, 710-11 (Del. 1983) (concluding that total abstention by an individual who serves as a director of two corporations engaged in a transaction would serve the directors' duty of good management to both corporations, and result in no liability for the individual). *See also In re Tri-Star Pictures, Inc., Litig*., 1995 WL 106520, at *2 (Del. Ch. Mar. 9. 1995) (stating that "Delaware law clearly prescribes that a director who plays no role in the process of deciding whether to approve a challenged transaction cannot be held liable on a claim that the board's decision to approve that transaction was wrongful."). The Commission could implement a similar standard to evaluate the fairness of a transaction entered into between a fund's portfolio investment and an

should also be excluded from the definition due to the lack of involvement by such advisers in these decisions. That said, we recognize that where the retention of the adviser or a related person is a pre-condition of the private fund's investment in a portfolio investment—such as requiring that an affiliate be retained to provide consulting services to a portfolio company, or that an affiliate be appointed as loan servicer prior to making a loan to a borrower—excluding such arrangements from "portfolio investment compensation" would not be consistent with the Commission's policy goals in this area, and we are not proposing to exclude such arrangements (even where the adviser will not have control or influence after the private fund has made its investment).

Absent this clarification, we are concerned that under the quarterly reporting requirements of the Proposed Rule, such corporate issuers (and underlying funds) could be viewed as giving rise to portfolio investment compensation for which an adviser would be required to provide extensive disclosures that it cannot readily obtain without re-negotiating existing confidentiality agreements or violating internal policies on information flow, even though the adviser played no role in causing the compensation to be paid. Accordingly, we urge the Commission to clarify the definition of portfolio investment compensation to exclude the types of compensation that would be viewed as "attributable to" the private fund's investment, as described above.

E. Clarify that existing approval mechanisms can provide appropriate oversight with respect to transactions

As support for the Commission's departure from a disclosure/consent-based approach, the Commission repeatedly references the limitations on the governance structure for private funds.[62] While acknowledging that some private funds do have governance structures, such as a limited partner advisory committee ("**LPAC**") or a board of directors, the Release states that those types of bodies "may not have the necessary independence, authority or accountability to oversee and consent to conflicts and other harmful practices" and that private funds overall do not have "comprehensive mechanisms for private fund investors to exercise effective governance."[63] We disagree. In fact, many private funds make use of robust LPACs, independent directors, independent representatives, or third-party fiduciary processes, recognizing the importance of the adviser's fiduciary responsibilities to the private fund. Such bodies or representatives are often used to evaluate potential conflicts of interest involving the adviser and its related parties as well as reviewing and approving (or rejecting) transactions requiring consent under the Advisers Act, such as principal transactions under Section 206(3). Private funds may alternatively seek informed consent for those types of transactions and waivers of conflicts from unaffiliated investors holding the required percentage in the fund's constituent documents (typically a majority of the total voting interests held in the private fund), coupled with full and fair disclosure provided to all investors of conflicts of interest specifically relating to the matter to be voted upon and generally through the private funds' offering memorandum and governing documents. The Release's suggestion with respect to the insufficiency of those forms of governance structures may inadvertently and

affiliate of the fund's adviser: even if the fund has a control position in a portfolio investment, if the adviser and its representatives recuse themselves from the totality of the portfolio investment's decision to retain an affiliate of the fund's adviser, the transaction can be completed in a fair manner for all parties.

[62] *See, e.g.,* Release at 13-16, 132-133, and 187-188.

[63] Release at 13.

unnecessarily cast doubt on the validity of decisions and consents made by LPACs and other similar investor bodies or representatives, despite their *bona fide* efforts to consider and reach decisions that are in the best interests of the private fund and its investors, and potentially undercuts decades of established practices with regard to previously used approval mechanisms.

We urge the Commission to recognize that, consistent with the 2019 Fiduciary Interpretation, any of the foregoing mechanisms for obtaining informed consent are and remain valid. We believe that, consistent with prior Commission rules and guidance, advisers should have the flexibility to implement any of the foregoing mechanisms depending on the circumstances of the investor pool, the type of fund structure (e.g., closed ended or open ended), investment strategy or other negotiated terms. For example, hedge funds do not typically use LPACs. LPACs in a typical private equity fund can provide informed consent when a fund adviser seeks to deviate from previously agreed limitations on investments or seeks to enter into transactions with certain related persons. In other circumstances, a fund may determine to rely on an independent representative to provide consent on behalf of investors to certain types of cross trades. Advisers and their investors should have the ability to determine the appropriate mechanism for obtaining consent as was recognized in the 2019 Fiduciary Interpretation.

Moreover, we believe that private funds should continue to be able to retain flexibility to adopt the appropriate governance structure for reviewing and approving conflicted transactions and other matters presented by the fund's adviser.[64] We do not believe that the Commission should itself prescribe any particular form or content for any governance structure, or override a governance structure that has been agreed with investors. Instead, if a governance structure has been approved by investors (as reflected in their decision to invest in the fund (or has otherwise been approved by a necessary vote to amend the fund's governing documents, as applicable), that governance mechanism should be permitted to waive, on behalf of the fund, potential conflicts. Correspondingly, if any aspect of the Proposed Rule is adopted, we believe that the prior investor-approved governance mechanism should be permitted to waive, on behalf of the fund and its investors, any requirement of the adviser to comply with any aspect of the Proposed Rule as finally adopted.[65]

The Release also suggests that LPACs do not provide effective governance because (among other reasons) LPAC members can take into account their own interests and do not have a duty to the fund's other investors.[66] However, this is a condition of service required by many

[64] By way of example only, some private funds have established LPACs with a majority of members who are independent from the adviser and such LPACs have developed procedures covering the disclosure of material conflict of interests and/or potential recusal.
[65] By way of example only, subject to adequate disclosure and authorization under a fund's organizational documents, a fund's LPAC could determine to waive the requirement to obtain a fairness opinion in connection with an adviser-led secondary transaction where it determined that such a fairness opinion was not necessary or cost-effective in connection with a particular transaction. We believe such an approach would be more consistent with the Commission's historical principles-based approach to disclosure and consent of conflicts of interest.
[66] Release at 13 (noting that the interests of one or more private fund investors may not represent the interests of (or may otherwise conflict with the interests of) other investors in the private fund and that certain fund governance agreements may permit LPAC member investors to exercise their rights in a manner that places their interests ahead of the private fund or the investors as a whole).

institutional investors (not one imposed by fund advisers) and is implemented to help ensure a broad, diverse, and knowledgeable governing body. Moreover, as described above, many private funds already utilize what advisers believe are effective LPACs and other similar independent bodies to make good faith considerations of transactions and arrangements implicating conflicts of interest on behalf of a private fund and its investors. LPACs and other similar independent bodies also serve as an efficient means for the timely review and approval of these types of transactions as seeking the consent of a private fund's limited partners may prove impractical given potential external commercial and investment timing constraints. Invalidating the wide use of LPACs may also create a vacuum as to appropriate and practical alternatives that private funds can pursue with respect to pursuing an independent consideration of these issues or may lead to private funds not considering potential investments that may otherwise have been available had an LPAC been in place. As an alternative to many of the rules proposed, the Commission could also have considered whether to simply impose specified requirements on LPACs or other governance structures to achieve the level of oversight and review the Commission believes is lacking, rather than to outright prohibit common market practices that have been negotiated and agreed with investors.[67]

We also note, as further discussed in Section V.A.1 below, that we believe it is of great importance that the current "gross negligence" standard that is applicable to service on any of the foregoing mechanisms for obtaining informed consent, including LPACs, be continued. Because LPAC members are typically "indemnified persons" under the constituent fund's documents, their ability to be indemnified by the funds to which they act as LPAC members rest on their not acting with "gross negligence" rather the proposed "negligence" standard. Should that standard be lowered to mere "negligence," we are gravely concerned that investors will be unwilling to serve on LPACs.

F. Exclude certain advisory relationships

We request that the Commission clarify whether the Proposed Rule would apply to sub-advisers who manage a sleeve of a portfolio or otherwise only manage a sub-set of a private fund's assets, and if so whether the full scope of the Proposed Rule would apply to the entire private fund or only the relevant sub-set of assets.[68] We urge the Commission to generally exclude (or, failing that, provide a narrower application of the Proposed Rule) sub-advisory relationships where the subject private fund is not controlled by or under common control with the relevant sub-adviser. At a minimum, with respect to reporting requirements, we request the Commission incorporate a standard similar to what is currently used in the instructions to Form ADV – i.e., where an adviser is only required to report information with respect to the portion of the portfolio that is managed

[67] *See also* Release at 161, in which the Commission sought for comment on whether borrowing by an investment adviser should be permitted if it is subject to specific governance and other protections (*e.g.*, advance disclosure to all investors, advance disclosure to an LPAC or similar body, consent of a governing body such as an LPAC, and/or consent of a majority or supermajority of investors).

[68] We are concerned, for example, that non-U.S.-based fund managers that would not be subject to the Proposed Rule would have a strong disincentive from hiring U.S.-based managers as sub-advisers if doing so would require comprehensive modifications to fund terms and disclosures in order to conform the fund to the requirements of the Proposed Rule (which only arise due to retaining the sub-adviser subject to the rules).

by the adviser (and not the full private fund itself),[69] and that the sub-adviser's obligation to "distribute" reports be satisfied through delivery to the primary adviser to the private fund (so long as it is not a related person of the sub-adviser). Similarly, we believe that it would be appropriate to carve out from the Proposed Rule any private funds over which an adviser provides non-discretionary investment advice, because in this instance an adviser has limited access to private fund information (if any) and ability to control or direct the investment activities of the private fund; in this case, the potential for conflicts is highly mitigated, and the scope of the Proposed Rule should not apply.

V. COMMENTS WITH RESPECT TO SPECIFIC ASPECTS OF THE PROPOSED RULE

A. Comments with respect to Prohibited Activities in the Proposed Rule

1. Limitations on an Adviser's Liability

General

The 2019 Fiduciary Interpretation, recognizing the breadth and variety of contractual arrangements for advisory services and the Commission's long-standing view that more sophisticated investors require less protection, held that the sophistication level of the client is relevant in determining whether an indemnification clause is consistent with the Advisers Act. The Proposed Rule instead imposes a market-wide standard of liability that is more onerous than the standard applicable to RICs and their advisers.

Under the Proposed Rule, a private fund adviser could not, directly or indirectly, seek reimbursement, indemnification, exculpation, or ***limitation*** of its liability from a private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to such private fund. As discussed in Section II.A, we believe this kind of direct requirement for an adviser's contractual provisions exceeds the SEC's statutory authority, and is without merit because it would nullify negotiated agreements between sophisticated parties.

In the Release, the Commission requested specific comments on whether this aspect of the Proposed Rule should be modified. We strongly believe it should. We have significant concerns regarding how this Proposed Rule is constructed, in part due to the its overly broad application, its impact on long-standing and widespread industry practice and its potential conflict with state law. We urge the Commission to modify the Proposed Rule to: (i) apply only to the provision of ***advisory*** services, rather than ***any*** "service" as used in the Proposed Rule, (ii) permit the contractual waiver of fiduciary duties and other liabilities in situations where state law permits

[69] See instruction to Form ADV, item 5.K.(1) and (2) (which only requires reporting for the portion of a separately managed account that an adviser sub-advises) and item 5.F(2) (which specifies that for purposes of determining regulatory assets under management, an adviser that manages a portion of a securities portfolio should only include the portion over which the adviser provides such services).

such waiver and (iii) only prohibit an adviser from obtaining reimbursement, indemnification, exculpation or limitation of its liability for "*gross* negligence" rather than ordinary negligence.

First, we are concerned that the scope of the Proposed Rule would encompass activities related to, but not actually involving, advisory services. In addition to investment advisory services, advisers or their affiliated entities provide administrative and operational services to private funds, and the overwhelming industry standard for such services is gross negligence – whether the service is provided by the adviser or an unrelated third party. Therefore, we urge the Commission to modify this element of the Proposed Rule to apply only to advisory services, and not any or all services provided by an adviser or its related persons. We also request clarification that proposed rule 211(h)(2)-1 would *not* cover related persons providing non-advisory services to the private fund.

Second, the Commission expressed the concern in the Release that advisers have, with the consent of their investors, exercised their full rights under state law to waive state-law fiduciary duties. In the Release, the Commission states that under the Proposed Rule, an investment adviser would be prohibited from seeking indemnification for breaching its fiduciary duty, without regard to whether state or other law would permit an adviser to waive its fiduciary duty.[70] We do not believe that the Commission has authority to prohibit a waiver of state law fiduciary duty where state law permits contracting parties to modify or adjust a general partner's state-law fiduciary duties. Moreover, as noted above, this reflects a radical, unexplained, and unsupported departure from the 2019 Fiduciary Interpretation, which explicitly recognized that an adviser's "fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."[71] We continue to support the distinction between fiduciary duties under federal law versus state law. As discussed below, we believe the Release does not adequately address the potential costs of shifting to a "simple negligence" standard, but we further note that with respect to *this* issue related to a breach of fiduciary duty, the Economic Analysis does not address the issue at all, and therefore we do not believe that the Commission has satisfied the requirement to demonstrate justification for the Proposed Rule's ban on an adviser's ability to limit its liability for a breach of fiduciary duty.

Third, most, if not all, advisory contracts, seek to allocate risk between an adviser and its clients, and as a result advisory contracts typically include limitations on liability. Correspondingly, the Release fails to provide an accurate estimate of the potential impacts and consequences of this aspect of the Proposed Rule, given the widespread use of exculpation and indemnification clauses. A proposal to bar investment advisers from limiting their liability in the case of *simple negligence* for any service – a standard that does not apply even in the case of

[70] Release at 151.

[71] 2019 Fiduciary Interpretation at n.26 and accompanying text. The Commission explicitly did not take any position on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law. *Id.* at n.31. We believe any prohibition on modifications of state law fiduciary duties would substantially undermine the ability of advisers and clients to "shape" their relationship as they mutually agree, with appropriate disclosure and consent.

advisers providing advisory services to mutual funds for the retail market[72] – is one of the most abrupt and radical departures found in the Proposed Rule, and has no rationale for its support.

The Commission asks whether "this aspect of the final prohibited activities rule should prohibit limiting liability for 'gross negligence,' or would prohibiting limitations of liability for ordinary negligence, as proposed, be more appropriate?"[73] Private funds and separately managed account agreements overwhelmingly include gross negligence but not ordinary negligence within the scope of investment adviser liability. In fact, except with respect to separate accounts managed on behalf of employee benefit plans subject to the Employee Retirement Income Security Act of 1974 ("**ERISA**"), or when plan assets in commingled funds become "significant" under ERISA (where a "prudent person" standard of care is required by law), simple negligence is almost never within the scope of liability. Gross negligence is the type of negligence included in the scope of liability because advisers are paid to put money to work in an efficient manner, and there is concern that advisers would be paralyzed by the fear of aggressive legal challenges to their decisions based on factors which were only apparent in hindsight. Investors want managers to invest their assets and make reasonable, educated choices about how much time and investor money should be spent on each investment decision. Investors do not want advisers to spend excessive amounts of investor money, or be overly reluctant to enter into purchases and sales, in order to insulate the adviser from potential litigation. This is especially true in more risky asset classes (*e.g.*, venture capital and emerging market investments where there may be limited due diligence materials available, as well as innovative asset classes, such as digital assets). Investors have not demanded that sponsors spend more of their capital investigating investments.

Requiring investment advisers to be liable for simple negligence (vs. gross negligence and other causes of action) would expose advisers to increased litigation and threats of litigation, and, over the longer-term, would inhibit and delay the exercise of investment discretion, resulting in potentially lower returns. Related court precedent from Delaware, one of the pre-eminent corporate law jurisdictions and the jurisdiction of organization for most private funds organized under U.S. law, recognizes the "substantial differences"[74] between simple (or ordinary) negligence, which essentially imposes a prudent person standard,[75] as compared to gross negligence, which is defined as conduct that represents an "extreme departure from the ordinary

[72] Indeed, we note that the Investment Company Act, a more prescriptive regulatory regime, establishes a gross negligence standard of care (as a minimum) for investment advisory and principal underwriting agreements with RICs. Under Section 17(i) of the Investment Company Act, an investment adviser or principal underwriter to a RIC may limit its liability to losses other than those resulting from its willful misfeasance, bad faith, or *gross negligence*, in the performance of its duties, or by reason of its reckless disregard of its obligations and duties under such contract or agreement. We do not believe the Commission has provided any justification for requiring a higher standard of care for an adviser to a private fund with sophisticated investors that is *not* required to register under the Investment Company Act than for an adviser to a RIC that is so registered.
[73] Release at 152.
[74] *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 651-652 (Del. Ch. 2008)(hereinafter "***Lear***").
[75] Under Delaware law, "simple negligence" is the "care that an ordinarily prudent person in a similar position would use under similar circumstances" and "is a higher standard than the common law imposes on a corporate fiduciary." *MKE Holdings Ltd. v. Schwartz*, No. CV 2018-0729-SG, 2019 Del. Ch. LEXIS 1285, at *23 (Del. Ch. Sept. 26, 2019) (quotation marks omitted)..

standard of care."[76] A claim for ordinary negligence under Delaware law can be established from conduct that results from simple "ordinary inadvertence or inattention"[77] while for gross negligence, a "plaintiff must plead and prove that the defendant was recklessly uninformed or acted outside the bounds of reason."[78] Given the vast gulf between simple negligence and gross negligence, private fund advisers potentially would be exposed to greater liability for even simple foot-faults and may decline or avoid many types of investments typically pursued in the private fund industry (including but not limited to more complex but potentially higher performing investments) due to fear of investor litigation.

Delaware precedent imposes a gross negligence standard with respect to whether directors have breached their fiduciary duty, finding that a gross negligence standard (as opposed to a simple negligence standard) ensures that "directors are not unduly hampered in taking good faith risks."[79] Other Delaware precedent notes that this gross negligence policy standard aligns with shareholder interests, explaining that "shareholders don't want (or shouldn't rationally want) directors to be risk averse" and that "shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital."[80]

This in part explains why private funds generally limit liability for negligence (i.e., apply a gross negligence standard), such that it is now considered market standard in the investment management industry—interests of investors and advisers alike are generally aligned when an adviser is empowered to take reasonable risks (commensurate with proper disclosure) in pursuing a fund's stated investment objectives and strategies. Importantly, the Proposed Rule's deviation from the existing market liability standard will lead to higher insurance premiums for the adviser and the private fund's service providers. We expect that increased expenses would be passed through to investors.[81] In addition, imposing a simple negligence standard may also make fund

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[76] *Greenfield v. Miles*, 211 A.3d 1087, 1101 n.74 (Del. 2019) (quoting *Browne v. Robb*, 583 A.2d 949, 953 (Del. 1990) and citing 11 Del. C. § 231(d)); *Jardel*, 523 A.2d at 530.
[77] *Jardel Co. v. Hughes*, 523 A.2d 518, 530 (Del. 1987).
[78] *Metropolitan Life Ins. Co. v. Tremont Gp. Holdings, Inc.*, 2012 Del. Ch. LEXIS 287 (Del. Ch. Dec. 20, 2012); *Firefighters' Pension Sys. v. Presidio, Inc.*, 251 A.3d 212 (Del. Ch. 2021); *Albert v. Alex. Brown Mgmt. Servs.*, 2005 Del. Ch. LEXIS 133 (Del. Ch. Aug. 26, 2005).
[79] *Lear* at 651-52.
[80] *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996). The Delaware Court of Chancery also noted that "it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss." Id. at 1052. *See also In re Caremark Int'l Inc. Derivative Litig*., 698 A.2d 959, 968 (Del. Ch. 1996) ("It is doubtful that we want business men and women to be encouraged to make decisions as hypothetical persons of ordinary judgment and prudence might. The corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what persons of ordinary or average judgment and average risk assessment talent regard as "prudent" "sensible" or even "rational", such persons will have a strong incentive at the margin to authorize less risky investment projects.").
[81] To the extent that fund governing documents provide for adviser-affiliated persons and LPAC members to be treated alike for purposes of indemnification and exculpation, a change to the adviser's status could have a direct impact on potential liability for LPAC members, with a result that LPAC members would no longer be protected personally from

advisers less willing to agree to investor-friendly termination or removal provisions which often do not require investors to take fund sponsors to court to prove any specific wrongdoing.

Moreover, as noted above and given the disparate impact of the rule on U.S. advisers vs. non-U.S. advisers, the change in market standard is likely to result in a competitive advantage for non-U.S. advisers and foreign government-controlled sovereign wealth funds, enabling them to pursue deals with fewer "defensive" protective measures (thereby offering the underlying sellers a faster and more certain closing) than U.S. counterparts that face heightened liability. Even if the Commission were to modify its approach to subject SEC-registered non-U.S. managers to "substantive" regulation under the Advisers Act, including the Proposed Rule, there are many other non-U.S. fund sponsors (such as exempt reporting advisers) that would obtain a competitive advantage. Non-U.S. fund sponsors may also cease to offer their funds to U.S. investors, choosing instead to retain the gross negligence standard outside the United States. In both instances, a simple negligence standard could thus deprive U.S. investors of the potential benefits of the "complexity premium" that often makes private fund investments an attractive asset class.

Finally, we believe it is important to note that under the federal securities laws, the Commission itself must satisfy different standards to prove the elements of a claim depending on the facts of a particular matter. As noted in multiple recent Commission enforcement cases, a claim brought under Section 206(1) of the Advisers Act requires a showing of *scienter*, and actions brought under Section 207 cannot be based on negligence.[82] Outside the Advisers Act, as one of many examples, to succeed in a Rule 10b-5 fraud claim, the Commission must prove: (i) a false statement or omission of material fact; (ii) made with *scienter*; (iii) justifiably relied upon; that (iv) caused injury.[83] In contrast, Advisers Act Section 206(2) only requires a showing of negligence.[84]

Although the Proposed Rule would not alter the SEC's standards of proof, they could in effect impose strict liability on advisers, if such contracts contained provisions limiting an adviser's liability for negligent acts for any service, regardless of whether an adviser took advantage of its indemnification rights and regardless of whether the client actually suffered any harm.

While the Commission can, in certain circumstances, initiate actions arising out of negligent conduct, a different standard exists for private rights of action. Under long-standing case law,[85] advisory clients (and presumably private fund investors) have a limited private right of

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claims arising from negligent behavior in their service on the LPAC. We believe this would have a chilling effect on investor willingness to serve these important functions.

[82] *See The Robare Group, Ltd. v. SEC*, 922 F.3d 468, 472 (D.C. Cir. 2019) (citing *SEC v. Steadman*, 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992)). *See also Malouf v. SEC*, No. 933 F.3d 1248, 1263 (10th Cir. Aug. 13, 2019) (citing *Robare Group*, 922 F.3d 468).

[83] *Robbins v. Koger Props., Inc.,* 116 F.3d 1441, 1447 (11th Cir. 1997) (citing *Bruschi v. Brown*, 876 F.2d 1526, 1528 (11th Cir. 1989)).

[84] *See Robare Group*, 922 F.3d at 472 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 195 (1963)). *See also Malouf*, 933 F.3d at 1263 (citing *Robare Group*, 922 F.3d 468).

[85] *Transamerica Mtg. Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (holding that Section 215 of the Advisers Act (which states that a contract made in violation of the Advisers Act is void) provides only a specific and limited remedy when voiding these certain investment contracts, and that Congress intended that the typical legal outcomes to a voided

action for breach of fiduciary duty by an adviser, which would allow those clients to void the contract and thus recover fees paid, but not monetary damages for bad performance (or losses) of the private fund. The Proposed Rule could in effect expand an advisory client's ability to void contracts, but also facilitate an investor's ability to bring a suit under state law (for the reasons cited above). Moreover, because of the lower standard necessary to present a valid claim for simple negligence, we anticipate that even meritless claims will have a significantly increased ability to survive a motion to dismiss or a motion for summary judgment, potentially resulting in a *significant* increase in litigation—a boon for plaintiffs' lawyers and defense lawyers alike, but perhaps less so for both fund investors and fund advisers.

Additional Considerations for CLOs

All of the reasons identified above for traditional private funds are heightened in the case of CLOs. CLO management agreements and indentures typically prescribe various rules to govern a collateral manager's management of the portfolio, impose detailed overcollateralization and collateral quality tests, and require monthly reports to noteholders in the CLO confirming compliance with such tests. In virtually every CLO, a collateral manager is liable for gross negligence, reckless disregard of obligations, bad faith or willful misconduct under CLO management agreements. Not only have CLO investors agreed to this standard, but investment banks that serve as arrangers for CLOs and provide warehouse financing, and rating agencies that scrutinize the documents and rate the secured notes issued by CLOs, have also agreed to this limitation of liability for CLO managers.

We believe the market has demonstrated that the limitation of liability that is standard in CLOs has worked effectively. CLOs have performed well for over 20 years, even during the Global Financial Crisis ("**GFC**") and its aftermath. CLO debt tranches rated AAA or AA by Standard & Poor's, for example, experienced absolutely no loss at all during the GFC.[86] Even among below investment grade CLO tranches, defaults were minimal, comparing very favorably with the percentage of corporate loans rated below investment grade that had defaulted, and this performance has continued since.[87] Not only have CLO debt tranches performed well over time; cash-flow reporting indicates that CLOs have had 11 straight years of double-digit cash flow returns.[88] Instances in which investors or regulators have claimed that CLO advisers have mismanaged CLO portfolios are quite rare, and the market has seen that existing regulatory enforcement tools have been effective at addressing isolated cases of mismanagement.[89]

Beyond the substantive problem with upsetting the well-established approach to liability limitation in CLOs, as indicated above, it would be difficult to alter the management agreement terms in existing CLOs. As stated above, in many CLOs, an amendment of the management

contract would follow such a finding; also holding that Section 206 of the Advisers Act does not infer the existence of a private cause of action for violations thereof).

[86] "S&P: CLOs show strong historic performance with few defaults," S&P Global, January 31, 2014.

[87] *Id.*; "S&P: CLO Spotlight: U.S. CLO Defaults as of March 17, 2022," S&P Global.

[88] J.P. Morgan, "CLO Outlook," U.S. Fixed Income Markets 2022 Outlook Conference, November 30, 2021; J.P. Morgan, "CLO Equity: Maverick to Mainstream," October 30, 2020.

[89] *See In re* Lynn Tilton, Patriarch Partners, LLC, Patriarch Partners VIII, LLC, Patriarch Partners XIV, LLC and Patriarch Partners XV, LLC, Advisers Act Release No. 4053 (March 30, 2015).

agreement will, in addition to the consent of the issuer and the collateral manager, also require consent of a majority of the most senior notes and a majority of the subordinated notes/equity.[90] It is quite possible that one class or the other will not provide its consent, and as noted previously, given that CLO interests are generally traded via clearing exchanges, it may be impractical to reach such consent thresholds. For example, the holders of the subordinated notes could well determine that expanding the scope of the CLO manager's liability would have a chilling effect with respect to its management of the portfolio, and reduce returns to the subordinated notes. We believe it is clear that any amendment process for CLOs may well be cumbersome and time consuming, and could potentially extend for an indeterminate period of time, outside of the control of the adviser.

2. Reducing the Adviser/GP Clawback by Actual/Potential Taxes

Under the Proposed Rule, advisers would be prohibited from reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.[91] This prohibits an industry standard practice and may cause carry recipients to bear the tax liability with respect to income for which they have not received a corresponding cash distribution. The Commission has suggested a number of ways for fund sponsors to more closely align carry distributions to the carry recipients and the tax burden associated with the carried interest. However, as discussed below, we believe that these suggestions are ineffective for aligning carry distributions and their associated tax burden, may lead parties to renegotiate fund terms resulting in a market shift that complies with the Proposed Rule but is adverse to fund investors in general, and could provide comparative advantages to funds and certain managers that would not be governed by the Proposed Rule.

First, the Commission suggests that the discrepancy between cash distributions and the tax burden to carry recipients may be addressed by the fund's general partner (or equivalent) deferring or escrowing carry distributions until there is more certainty regarding the profitability of the fund. For example, the Commission suggested that a fund can adopt a "European"-style waterfall that would delay carry distributions to the carry recipients until all of the investors in the fund have received their capital and preferred returns. However, this suggestion does not account for the fact that the U.S. Internal Revenue Code (the "**Code**") requires a fund to allocate income to the carry recipients for each taxable year when the fund recognizes income in excess of preferred returns, irrespective of whether there is a corresponding distribution of cash to the carry recipients in such year. As a result, in most cases, the carry recipients would be required to recognize income annually to the extent the fund generates sufficient income or gain *even if* the fund were to adopt a European-style waterfall. This point is further illustrated in Appendix A. The same would also

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[90] Members indicate that notes are typically held by a large number of holders, obviously complicating efforts to request such a consent, particularly where such notes are traded through clearing exchanges, making it more difficult for CLO managers to even identify the parties from whom consent would be sought.

[91] Please note that for ease of the Commission's review, our commentary in this section is generally drafted from the perspective of a private fund organized as a limited partnership where the fund's general partner, an affiliate of the fund's investment adviser, receives performance-based compensation in the form of carried interest. In actuality, it is often the case that individual employees (and former employees) of the adviser will be the ultimate recipients of all or a portion of the carried interest initially received by the general partner, and accordingly the unforeseen complications discussed in this section as applied to the "general partner" would also apply to such individual carry recipients. Our comments will also generally apply to any similar organizational and compensation structures.

be true if the fund decides to escrow carry distributions. Accordingly, it is incorrect to assume that simply deferring or escrowing carry distributions can defer taxable income allocations to the carry recipients. Because, in most cases, carry recipients will recognize income on an annual basis, they would also have a corresponding tax liability—even if they had not *actually* received any distributions. Fund documents negotiated with investors typically address this tax liability by making a tax distribution to carry recipients (and in some cases investors) to help ensure that they do not need to pay the taxes out of pocket.

The general partner may be able to defer income allocations until carried interest is actually distributed, if the fund were to restructure carried interest as a performance *fee* (*i.e.*, a payment by the fund to a service provider) rather than as a distributive share of income (*i.e.*, income allocation to the carry recipient as a partner in the fund).[92] However, from a tax standpoint, performance *fees* are fundamentally different from the carry arrangement that is typical in most private funds, and are generally tax inefficient not only for the carry recipients but *also* for U.S. investors in private funds. Specifically, U.S. taxable investors would be required to report their income on a gross basis before the reduction of such performance fees for federal income tax purposes, and any performance fees paid would be reported as deduction items that are subject to deduction limitations for such investors and in many instances would be completely non-deductible. If carry recipients were not permitted to take into account their tax liabilities in computing the clawback amount, certain carry recipients would be incentivized to adopt a performance fee arrangement to mitigate the risk of bearing tax liabilities with respect to income for which they did not receive a corresponding cash distribution. For example, non-corporate carry recipients in a fund that generates mostly ordinary income (such that the carried interest structure would not meaningfully provide carry recipients with the benefit of capital gain treatment) would likely find a performance fee arrangement more appealing than carried interest because the former would allow them to defer income recognition until performance fees are actually paid. The same is true for corporate carry recipients that do not benefit from the preferential tax rates on capital gains. Accordingly, to the extent that this aspect of the Proposed Rule incentivizes private fund advisers to reformulate their performance-based compensation as performance fees, U.S. taxable investors (typically individual investors) will be directly and negatively impacted by such change. This issue is illustrated in the examples set forth in Appendix B.

Second, the Commission suggests that the carry recipients may be able to obtain a tax refund by amending federal income tax returns for prior years. However, we believe the Commission's suggestion is not a workable solution for a number of reasons. Importantly, a carry recipient is generally not permitted to retroactively amend its tax return from a prior year to reflect the clawback payment. Moreover, even if a carry recipient *could* retroactively amend its federal income tax returns, the fund would be required to amend its federal income tax returns *and that amendment would require the amendment of tax returns for all of the fund's investors and carry recipients alike*, which will then have the cascading effect of requiring amendments to the federal

[92] Note there are significant limitations on deferral even in the context of performance fees due to Sections 409A and 457A of the Code. In fact, Section 457A of the Code was implemented specifically to prevent fund managers from deferring performance fees in investment funds. Any deferral of performance fees not in compliance with Section 457A of the Code can lead to a 20% penalty tax, in addition to performance fees already being treated as ordinary income.

income tax returns of the beneficial owners of private fund investors. Furthermore, the amendments to investors' federal income tax returns would likely cause unwelcomed confusion and uncertainty, as well as additional costs for investors, given that audit costs and tax reporting costs are borne by investors. In addition, corresponding amendments may be required for tax returns in subsequent tax years after the initial amendment, which will further exacerbate the problem. Accordingly, in many cases, the carry recipient may have to claim a deduction of the clawback payment as a loss item in the year of the clawback payment.[93] Although claiming a deduction may provide some relief, the carry recipient may not be able to claim a full deduction of the loss (and thus may not be able to recover taxes paid in full) due to character mismatch,[94] various deduction limitations, and potential tax rate changes between the year of income inclusion and the clawback year. This issue is illustrated in the examples set forth in Appendix C. Alternatively, carry recipients may be able to seek relief by claiming a reduction (or credit) of tax liabilities in the year of the clawback payment.[95] Significantly, however, any such reduction (or credit) of tax liabilities would only be available to the extent the carry recipient had an *apparent* (as opposed to an actual) unrestricted right to the carried interest distribution in the year of payment and it was subsequently determined that the carry recipient had no such right.[96] In the typical carried interest clawback, it is less than clear that the carry recipient would be treated as having had only an apparent right to the carried interest distributions in the year in which it was paid.[97]

Third, the Release indicated that rather than eliminating the after-tax clawback, the Commission had considered requiring the clawback amount to be reduced by *actual* tax liabilities instead of hypothetical ones. However, it appears that the Commission ruled out this possibility, noting that this approach may be impractical because it is unduly burdensome to require a fund to calculate the carry recipients' actual tax liabilities. We agree with the Commission that it would not be feasible to require all funds to use actual tax liabilities for this purpose, particularly in light of the fact that each fund may have different levels of complexity in the number, diversity, turnover

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[93] Additionally, it is common for some of the larger asset managers to share carried interest with employees via notional bonus plans (*e.g.*, synthetic carry plans). When a clawback happens in subsequent years for a fund adopting a notional bonus plan, there is significant uncertainty under Section 1341 of the Code regarding the ability to claim a deduction, and participants may have to fund a clawback gross of taxes despite already being taxed at ordinary income tax rates (which may be greater than 50% for certain carry recipients) on bonus payments. Further, in certain jurisdictions outside of the United States, such as the United Kingdom, there is no ability to reverse prior taxation on carried interest. Thus, this rule could force certain carry or performance fee recipients in these scenarios to lose money on the management of these funds, despite significant services having been rendered over the life of the fund.

[94] Specifically, subject to a *de minimis* exception in the case of a non-corporate taxpayer, a capital loss may only be used to offset capital gain. *See* I.R.C. § 1211. A clawback payment is typically treated as a capital loss because it is a payment with respect to a capital investment. Thus, the carry recipient may not be able to fully utilize the tax benefit of the loss if it has insufficient capital gain.

[95] *See* I.R.C. § 1341(a) (permitting a taxpayer to reduce his tax in the year of repayment by the greater of (i) the amount attributable to the deduction, or (ii) the amount attributable to the removal of the item in the prior year but only if, among other things, an item was included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to such item and it was subsequently established that the taxpayer lacked an unrestricted right to such amount).

[96] *Id.*

[97] *See generally* David Walker, *Executive Pay Clawbacks and Their Taxation,* No. 21-01 Boston University School of Law, Law and Economics Research Paper (2021) (discussing the scope of Section 1341 of the Code and noting that "[t]he IRS and courts have not settled on an interpretation of the language: 'appear that the taxpayer had an unrestricted right,' and the differences in interpretation create uncertainty with respect to the application of § 1341 to clawbacks").

rate and tax profiles of carry recipients, depending on how many employees (not just portfolio managers) share in profit distributions, where they reside, other sources of income, marital status and their respective marginal tax brackets. However, if the policy goal of the Proposed Rule is to prevent the carry recipients from receiving tax distributions in excess of actual tax liabilities, rather than completely eliminating the after-tax clawback limitations, the Commission should consider a more nuanced approach that would require using modified hypothetical tax liabilities that can better track the carry recipients' actual tax liabilities. For example, the Commission should consider requiring that the applicable tax rate reflect the highest marginal tax rate actually applicable to at least one of the carry recipients based on such carry recipient's residency.

In light of the above, we do *not* expect that the Proposed Rule will push the market toward back-end waterfalls, as the Commission suggests as a possible consequence. Rather, we expect that the Proposed Rule may lead to different practices that would be adverse to investors generally. For example, certain funds and sponsors may decide to migrate to non-U.S. jurisdictions in order to avoid application of the Proposed Rule entirely (*see* discussion in Section V.A above), certain funds may adopt performance fees in lieu of carried interest (which, as discussed above, would likely cause tax inefficiencies for U.S. taxable investors), and certain funds may decide to eliminate the clawback arrangement entirely (like in many open ended funds), eliminate interim clawbacks, or adopt a modified clawback arrangement that substantially reduces the circumstances in which a clawback would be triggered. Moreover, the Proposed Rule will likely place U.S. managers at a comparative disadvantage relative to non-U.S. managers managing non-U.S. funds that are not subject to the Proposed Rule. None of scenarios above appear to serve the best interest of the U.S. fund market or their investors.

For all of the above reasons, we urge the Commission to remove the prohibition on reducing clawbacks for actual, potential or hypothetical taxes as provided in proposed rule 211(h)(2)-1(a)(4). Instead, given the Commission's stated concerns in the Release, an alternative approach would be to have advisers include estimated clawback calculations reflecting any adjustments for taxes as part of the fund reporting requirements in proposed rule 211(h)(1)-2(b) (*i.e.*, the fund table on adviser compensation). Providing estimated clawback information on an annual basis to investors would enable investors to assess a potential clawback situation, and any potential reductions for taxes, that may arise. We believe that this approach would be more consistent with the Commission's long-standing principles-based approach to the Advisers Act.

3. Passing on Certain Costs and Expenses

Under the Proposed Rule, advisers would be prohibited from, directly or indirectly, charging certain types of specified costs and expenses to their private fund clients. Specifically, the rule would prohibit advisers from charging (i) a portfolio investment for monitoring, servicing, consulting, or other fees in respect of services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment, (ii) a private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, or (iii) a private fund for any regulatory or compliance fees or expenses of the adviser or its related persons. We address each proposed prohibition in turn below, but begin by providing our general views on these prohibitions.

As discussed in greater detail in Section III.B above, we believe the current regulatory framework already requires full disclosure and consent by the private fund investors prior to entry into an advisory contract among sophisticated parties who can fend for themselves, rendering these prohibitions unnecessary. The expenses an investor may or may not elect to bear in connection with an advisory contract should be determined by the investor, consistent with the incentives and financial strategy for which the investor has engaged the adviser. To the extent an adviser is required by law to go out-of-pocket for routine expenses, the end result is likely to be an increase in fees, perhaps accompanied by a disincentive to undertake reasonable risk and thus an unquantifiable diminution in overall performance.

It is also important to bear in mind the cost of recruiting and retaining a top investment team in a context where a significant portion of compensation is wrapped into a whole-fund waterfall that precludes payment until investors have received distributions in excess of their contributed capital. Until that point in time, investment professionals defer significant compensation in exchange for a salary and reasonable operating expenses, as well as an indemnity from the fund, absent disqualifying conduct. Regulating and diminishing those arrangements would potentially accelerate the movement of investment professionals to larger firms or other fields.

For many asset managers, the possibility that they would be responsible for both compliance costs and the fund's non-indemnified losses is difficult to accept. We cannot measure the effect of a regulation requiring asset managers to shoulder these costs and liabilities, but the calculus suggests the industry will see an exodus of talent, with a corollary chilling effect on capital formation. We understand the Proposed Rule does not explore or consider these effects as part of its cost-benefit analysis and respectfully submit that these aspects mitigate strongly against adoption of the Proposed Rule.

Overall, however, we urge the Commission to defer to the contracting parties and avoid imposing additional requirements in expense allocation, where powerful alignment of interest and disclosure duties already exist (and may be enhanced by other aspects of the Proposed Rule). The Commission's Proposed Rule would regulate an area that currently operates appropriately, in a manner that safeguards the interests of investors. We are concerned that the proposed regulation is not only unnecessary, but a danger to the incentive structure that has propelled the private fund industry and the U.S. capital markets to its greatest heights.

The Commission recognizes that some advisers use a pass-through expense structure where all or a substantial portion of the adviser's expenses are paid by the private fund. The Commission concedes that these advisers would be forced to re-structure their fee and expense model. Given that the Proposed Rule does not permit grandfathering, this change will result in substantial renegotiation of the terms of many existing funds, in a context where the adviser has little negotiating leverage, and may result in the early termination of impacted funds.

Funds using a "pass-through" expense model allocate to the funds the actual operating expenses associated with acting as the fund's adviser—including regulatory, compliance, and examination-related expenses, which would be subject to the proposed prohibitions. We believe these arrangements are the product of informed negotiations between sponsors and investors and reflect an understanding between sponsors and investors that these arrangements can effectively align the interests of both parties. We further note that these pass-through expense models are used almost exclusively in open-end products that permit redemptions, allowing investors that are dissatisfied with actual expense practices to "vote with their feet" and redeem out of the fund. We believe these commercial arrangements should be respected and allowed to continue without needing to be modified to meet the requirements of the proposed prohibitions. Furthermore, the practical effects of the Proposed Rule may not be what the Commission intends. The Proposed Rule focuses on preventing advisers from passing on to investors expenses that, from the Commission's perspective, should be for the adviser's account. However, the Proposed Rule does not prevent advisers from charging a management fee, nor does it mandate the amount of (or limit on) any such management fee. In lieu of quantifying their regulatory and compliance expenses to investors, advisers could simply charge a higher management fee in order to pay "overhead" expenses (which would generally include an adviser's regulatory and compliance expenses) but without a corresponding obligation to disclose any specific regulatory and compliance expenses to investors. As a result, investors would ultimately pay the adviser's regulatory and costs indirectly, with less transparency into advisers' actual costs of complying with the Commission's regulatory regime than they now have.

Moreover, advisers may in some instances be unable to increase their management fees to offset regulatory and compliance costs that previously were borne in part or in whole by private funds. This is likely to result in reduced investment in compliance functions, especially by smaller and new advisers, who often rely on management fees as their sole source of operating revenues and may not have other sources of capital with which to offset their increased regulatory and compliance costs. Discouraging advisers from investing in their compliance infrastructures would reduce investor protections and undermine regulatory and other initiatives intended to foster compliance.

The Proposed Rule will have a significant impact on efficiency, competition, and capital formation. The Commission's economic analysis incorrectly assumes that the Proposed Rule will set better terms for private fund investors,[98] lower the costs charged by private fund advisers,[99] enhance overall investor returns,[100] and induce new private fund advisers to enter the market.[101] In reality, departing from the Commission's well established focus on disclosure and informed consent, and voiding negotiated arrangements between private fund managers and sophisticated investors, will likely increase advisers' costs, reduce investor returns, and create new barriers to entry that decrease overall market competition and investor choice. The Commission makes no attempt to assess this impact beyond an acknowledgement that the Proposed Rule "does not preclude fund advisers from responding by raising prices of services."[102] In addition, the Commission often fails to distinguish between closed-end and open-end funds in its analysis, even

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[98] Release at 215-216.
[99] *Id.* at 265.
[100] *Id.*
[101] *Id.*
[102] *Id.* at 216.

though the redemption rights afforded investors in open-end funds, can, in many cases, help ensure an ongoing alignment of interests.

As a result of the above, we strongly encourage the Commission to withdraw this aspect of the Proposed Rule. To the extent a full withdrawal does not occur, we outline in section (a) to (c) below certain additional clarifications we believe are needed.

(a) Fees in respect of services that the investment adviser does not, or does not reasonably expect to provide to portfolio investments

We believe that this prohibition reflects the current state of the market for most private funds, but also note that this shift in market practice is the result of negotiations between fund sponsors and investors. We believe that this supports our contention that the Commission does not need to prohibit or require *commercial outcomes*, but can and should focus on ensuring that investors receive adequate disclosure to allow them to meaningfully negotiate with fund sponsors.

In response to one of the comments raised by the Commission, we agree that in situations where 100% of the economic benefit of portfolio investment fees has been shifted to private fund investors (through an offset, rebate, or otherwise), the adviser should *not* be viewed to be in violation of this proposed restriction. While the Commission is correct that certain tax-sensitive investors may waive their right to receive their share of rebates of portfolio investment fees, we do not believe that the Commission should prescribe any specific method of compliance, but should instead require that the treatment of such waived amounts should be fully disclosed to other private fund investors.

In addition, because this requirement applies "directly or indirectly," we are concerned that it could be read to apply to fees charged by an adviser's related persons even if such fees did not arise out of the private fund's investment in the portfolio investment. Accordingly, we urge the Commission to clarify that this prohibition would not apply to fees (i) charged by certain related persons that we recommend to exclude (as described in Section IV.C above), or (ii) that would not be "attributable to" the private fund's investment (as described in Section IV.D above).

(b) Fees or expenses associated with examinations or investigations of the adviser

While we believe this generally reflects current market practice for most funds other than pass-through expense funds (as noted above), we do not believe that this prescriptive prohibition is appropriate as it limits the ability of advisers and investors to freely negotiate the terms of their arrangement. In addition, we also request that the Commission clarify how this proposed prohibition will apply to certain situations that we believe may not have been contemplated by the Commission and for which we believe it would be appropriate for certain costs to be borne by private funds (with appropriate advance disclosure).

For example, the wording of this prohibition in the Proposed Rule may potentially raise a question of whether expenses related to an audit of a private fund by the Internal Revenue Service (or state or foreign tax authorities) could be borne by the private fund. We believe that sponsors and investors would generally agree that expenses related to a tax audit of the fund would properly constitute fund expenses, but because the fund may be "controlled" by the fund's adviser, it could be viewed as a related person, and thus the wording of the Proposed Rule could be read to require that such expenses be paid by the fund's adviser. Similarly, private funds may be reviewed by antitrust and competition authorities in connection with acquisitions of portfolio investments.[103] Under most circumstances, we believe it is appropriate for such costs to be borne by the private fund that has made or is proposing to make the acquisition that is subject to the review (or where the review relates to holdings or acquisitions made by multiple private funds or other clients advised by the same adviser, that costs be shared by such funds or other clients). Nonetheless, as noted above, the Proposed Rule could be construed to require such costs be borne entirely by the fund's adviser. We do not believe this is the intended outcome under the Proposed Rule, and we urge that the Commission clarify that examinations and investigations *of a private fund*, including, but not limited to audits and reviews by tax and competition authorities, would not be subject to this proposed prohibition.

We also request that the Commission confirm that investigations of *third parties* that require an adviser to incur costs related to activities of an advised private fund would not be within scope of this proposed prohibition. For example, private fund advisers routinely are asked to respond to inquiries by FINRA, by the Commission, and by other securities and regulatory authorities that are investigating insider trading or other conduct of third parties where the adviser (or its private fund client) has records or other information relevant to the authority conducting the investigation. Responding to such inquiries can result in incurring material costs, including advice of counsel or other advisers and service providers, and where such inquiries arise out of transactions considered or consummated on behalf of a private fund client, such costs are typically borne by such client (subject to appropriate authorization in the fund's governing documents and disclosures). Because such examinations or investigations are targeted at third parties, rather than the adviser or its related persons, we do not believe they would fall within the scope of this aspect of the Proposed Rule, even though certain document and information requests related to the examination or investigation may be directed to the adviser. We request that the Commission confirm that these types of third party investigations are not within the scope of the Proposed Rule.

(c) Regulatory and compliance fees or expenses

As above, we do not believe that this prescriptive prohibition is appropriate as it limits the ability of advisers and investors to freely negotiate the terms of their arrangement. We also believe this aspect of the Proposed Rule may be difficult to implement, and that accordingly fund sponsors and investors should simply address the allocation of these types of expenses through disclosure. We believe that the prohibition on charging investors for regulatory and compliance fees and expenses of the adviser or its related persons will likely be challenging for advisers to implement, as it is not always clear whether particular expenses, as a categorical matter, are adviser overhead or fund-related. As some examples, among many, we query whether Schedule 13D/13G filings, "HSR" filings or other regulatory filings that may be made by a fund's adviser on behalf of a fund would be considered subject to this prohibition. (We believe these types of uncertainties in categorization are reflected in the current market practice of providing a high level of detail

[103] See also our related comments regarding "HSR" filings and similar compliance costs in the following section.

regarding the expenses that may be borne by a fund.) Relatedly, it is not clear if the Commission intends that the expenses related to the quarterly statements and annual audits that it proposes to require would be borne by a given fund's investment adviser as "regulatory and compliance fees or expenses." We do not believe that investment advisers should bear the expenses of quarterly statements and audits related to funds.

The Release can be read to indicate that "regulatory and compliance fees and expenses" does not mean fees and expenses associated with statements or filings associated with a fund, but rather fees and expenses associated with the investment adviser. The Commission cites as examples "the compliance expenses related to advisers' registration with the Commission, including fees and expenses related to preparing and filing all items and corresponding schedules in Form ADV," and also "any expenses related to state licensing and registration requirements applicable to the adviser and related persons, including expenses related to registration and licensure of advisory personnel who contact or solicit investments from state pension or similar plans."[104]

That said, our members seek clarity. We request that the Commission clarify that investment advisers would not be required to bear expenses related to fund reporting. The Commission should consider providing additional guidance on this topic given the potential challenges in defining and interpreting the scope of the rule in its current form. Overall, we expect this aspect of the rule may result in an increase in management fees borne by funds and their investors, obscuring the true cost of compliance with the rules and increasing costs for investors overall.

4. Allocating Co-Investment Costs and Expenses on a Non-Pro Rata Basis

The Proposed Rule would prohibit an adviser from directly or indirectly charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-*pro rata* basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment.

We would in principle support a rule, as suggested in the Commission's specific request for comments, that allowed advisers to allocate fees and expenses in a fair and equitable manner and as supported by the deal terms, rather than requiring advisers to allocate solely on a *pro rata* basis.

While many advisers aim to charge such expenses *pro rata*, it is not always practicable or supported by the deal terms, or consistent with fair and equitable treatment of all clients participating in the investment. For example, it is somewhat common for situations to arise where co-investors in a given deal have specific expenses that relate solely to them—such as requiring a third-party valuation or credit rating, or other requirements that relate to the specific internal policy or regulatory requirements pertaining to the co-investor. The Proposed Rule would appear to require that such expenses of co-investors actually be charged to the investing private fund on a *pro rata* basis. And of course the same may be true in the reverse, where a fund has specific needs

[104] Release at 141.

in connection with an investment, but the Proposed Rule would seem to require that co-investors bear a *pro rata* share of those expenses. Similarly, in the case of transactions where the deal size is unknown before closing (for example, in an adviser-led restructuring where the deal size can vary dramatically based on which investors elect to participate), it may be nearly impossible to determine what *pro rata* even is. In the abstract, each situation may have a result that is not fair and equitable to the participating fund(s) and co-investor(s). We also note that under some circumstances, a non-*pro rata* allocation of expenses may in fact be more fair to participating clients and investors. For example, with respect to certain types of expenses—such as those related to preparing tax or regulatory filings in relation to an investment—the time and cost related to the activity does not correlate to the relative size of investments of participating investors, and accordingly allocating expenses *pro rata* by invested assets may simply result in larger investors (which are often the private funds) bearing a higher overall allocation of "fixed" costs. However, there may of course be situations where, on balance, it would still be advantageous to the private fund to bear expenses and be able to make an investment, if the alternative is that the fund would not be able to invest in the portfolio investment at all.

The Commission noted that charging fees on a non-*pro rata* basis places the interests of certain investors ahead of others and, in circumstances where one vehicle bears "broken deal" expenses and the other does not, provides the vehicle not bearing such expenses with the benefit of any upside in the event the transaction goes through without the burden of any downside in the event that it does not. However, in many circumstances, the "main fund" bearing a larger share of fees receives other benefits. For example, private funds frequently engage in co-investments when the fund, due to various considerations (often diversification constraints or general lack of capital) is unable to partake in the entire amount of an investment offered to it. It is to the fund's (and its investors') benefit for a related entity to purchase the remainder of the investment, as the combined power of both the main fund and the co-investment vehicle makes the aggregate buyers' position more desirable to the sellers, easier for the adviser to advance the interests of the main fund and the co-investment vehicle through a larger voting position, and may also make the position easier to exit later on. Importantly, co-invest vehicles generally do not charge fees (including broken deal expenses) and carry, or charge reduced fees and carry. Finally, it should be noted that investors in the main fund have not historically been opposed to this type of expense allocation as they believe they benefit from the participation of co-investors.

Finally, we note that this aspect of the Proposed Rule does not distinguish between non-*pro rata* allocations of fees and expenses that may occur due to different times at which investments occur. For example, a private fund (or group of funds) may incur research and other costs in connection with an investment in a company; the same research report may be used at a later period in time as part of an analysis for a different investment for a different client, such as a non-discretionary separately managed account client. We do not believe that this ban on non-*pro rata* allocation of fees and expenses should apply this case.

Private fund managers routinely, as part of their duties to fund clients, make these kinds of determinations after considering the types of facts and considerations noted above, and others, related to the specific deal. We believe that the Proposed Rule should not undermine these fact-specific determinations with an overly broad, one-size-fits-all approach to *always* allocate co-investment cost expenses in a specific way, foreclosing advisers' to make these deal-by-deal assessments—coupled with proper advance disclosure of practices and, where appropriate, transaction-specific consent consistent with the fund's governance mechanism.

5. Borrowing from Private Clients

The Proposed Rule would prohibit advisers from borrowing money, securities, or other assets, or receiving an extension of credit, from a private fund client (collectively, "**financing transactions**"). Under this Proposed Rule, advisers could lend to a private fund client but could not borrow from a private fund client, out of a stated concern by the Commission that an adviser could deplete a private fund's assets for personal benefit.

Adoption of the Proposed Rule would ban an activity that is *per se* permitted under the Advisers Act. Under Section 206(3) of the Advisers Act, a transaction involving a borrowing between an adviser and a private fund (whether as lender or borrower) could, depending on how such transaction is structured, be treated as a principal transaction requiring the consent of the client prior to the settlement of the transaction.[105] By its terms, Section 206(3) recognizes that such principal transactions are permitted to occur, provided that the relevant client provides informed consent to such a transaction prior to "settlement."[106] Under the 2019 Fiduciary Interpretation, the use of an independent representative or body, such as an LPAC, could provide this consent on behalf of a private fund client.[107] Therefore, we believe that adoption of the Proposed Rule would impermissibly restrict investment advisers from entering into financing transactions that are recognized by the Advisers Act as permissible under certain circumstances (including those that satisfy the conditions prescribed by previous Commission rules or interpretations and staff guidance). Under current principles articulated by the Commission in the 2019 Fiduciary Interpretation, advisers could obtain the consent of investors or an independent representative (such as an LPAC) prior to entering into potentially conflicted transactions between a private fund and the adviser (or its related persons). Such an approach would be consistent with prior Commission interpretation, enforcement cases and staff interpretations, upon which the industry and the market have relied in establishing and implementing their compliance programs.

We note that many ordinary course transactions could be interpreted as a "borrowing" or extension of credit and we request clarification that the following are not intended to be prohibited under the Proposed Rule:

- An advancement of expenses or other payments to an adviser or a related person, whether or not related to indemnification or taxes.[108]

- A pledge of private fund limited partnership interest, shares or other interests held by the adviser or a related person in connection with a loan issued by a third party

[105] *See* Section 206(3) of the Advisers Act.
[106] Interpretation of Section 206(3) of the Advisers Act, Advisers Act Release No. 1732 (July 17, 1998), *available at* https://www.sec.gov/rules/interp/ia-1732.htm.
[107] 2019 Fiduciary Interpretation.
[108] We provide this in response to the Commission's specific question in the Release (at page 160) asking whether tax advances should be excluded.

unrelated to or a related party that is operated independently of the adviser or related person seeking the pledge.

- A loan from the private fund to a borrower that may be an entity treated as a "related person" as a result of the control test (*e.g.*, where the borrower is itself a private fund, or where the borrower is an operating company that is owned by a private fund that is sponsored by an affiliate of the adviser).[109]

- Securities lending transactions where a private fund lends securities to a broker-dealer that is "walled off" from the business of the fund's adviser.

In conclusion, and for the reasons discussed above in Section IV.C, we do not support adoption of this aspect of the Proposed Rule as it applies to the adviser or any related persons of the adviser (so that the ban on "indirectly" entering into such financing transactions does not inadvertently capture such related persons). This aspect of the Proposed Rule is overly broad and could implicate (and impede) many ordinary course transactions that contribute to capital formation and efficient markets.

B. Comments with respect to Preferential Treatment under the Proposed Rule

1. Limiting the Scope of Redemption and Information Rights

The Proposed Rule contains a general prohibition on the granting of redemption rights or provision of portfolio information that, in either case, the adviser has a reasonable expectation, based on the facts and circumstances, would have a "material, negative effect" on other investors in the related private fund (or in a substantially similar pool of assets). We have significant concerns regarding proposed rule 211(h)(2)-3(a), as a matter of practical application for both open-ended and closed-ended funds. As an initial matter, we believe that the terms "substantially similar pool of assets" and "material, negative effect" are overly broad and would be difficult to apply, implement and monitor. Moreover, the standard set forth in the Proposed Rule requires the adviser to determine if there would be a material, negative effect on the "investors" of the private fund, suggesting that the burden falls on the adviser to second-guess each investor's individual circumstances rather than the impact on the private fund as a whole. This is contrary to current case law, which treats the private fund as the client of the adviser rather than each individual (or group of individual) investors.[110]

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[109] In addition, to the extent that the final rule does not provide for grandfathering of existing funds and arrangements (see also discussion in Section II.B, above), advisers may be prohibited from engaging in creditor-protective additional financing activity—such as restructuring or refinancing existing debt/loans—where the borrower is a related person operating company or otherwise affiliated with the fund's adviser because of an affiliate's control stake in the operating company. *See* Gardner Russo & Gardner, SEC Staff No-Action Letter (June 7, 2006). In such circumstances, the lending private fund would be effectively precluded or prohibited from entering into such transactions—even if it would directly benefit from the transaction, and even with the informed consent of the fund or its investors.

[110] SEC v. Goldstein at 881 (stating that a private fund advisor only owes a duty to the fund (the client) which it manages, and not to individual investors in such fund, "… the Commission's interpretation of the word 'client' comes

(a) Redemption and information rights allow investors to comply with law

We believe that flexibility regarding redemption rights is required in order to allow certain types of investors to comply with their own internally mandated laws; otherwise, we believe that such investors will face barriers to investment in private funds. Certain types of investors ("**Specialized LPs**") seek side letters terms which allow them to redeem from the private fund in order to comply with laws that impose strict conditions to investment. For example, pension plans formed for state or municipal employees are required to redeem from the fund if the fund's adviser or other related persons have paid placement fees and/or political contributions in certain contexts. Similar legal, regulatory and/or tax considerations apply to other Specialized LPs (*e.g.*, ERISA investors, charitable foundations, and other narrower categories of investors such as nuclear decommissioning trusts). In a closed-end fund, Specialized LPs may become subject to new laws, regulations or other policies that would require them to redeem from the fund, long after the commitment to the private fund has been made.

At the same time, Specialized LPs may seek the right to redeem (or the adviser itself may also seek an agreement with the Specialized LP that it can compel redemption) in order for it (or the fund) to comply with applicable law. For example, a fund may seek to redeem an ERISA investor in order to prevent the fund from becoming a plan asset fund (as required by the fund documents). Without this flexibility, the fund could violate ERISA rules unintentionally (merely because the ERISA investor remained in the fund). Moreover, for certain Specialized LPs, investment in an ERISA plan asset fund could result in a violation of internal policies or require enhanced reporting.

Absent an adviser extending agreed upon preferential liquidity to all investors, a broad prohibition on redemption rights could prevent sophisticated Specialized LPs, many of which currently invest substantial amounts in private funds, from further investing in private funds otherwise deemed to be appropriate for their needs.

For the same reasons cited above, Specialized LPs often seek enhanced reporting due to internal requirements, statutory obligations or other legal or regulatory mandates. Although an adviser generally provides significant portfolio information to investors, investors themselves are only required to provide the adviser with information relating to qualification to invest and, in those circumstances where the investor is seeking a side letter, information necessary for the adviser to determine how best to craft side letter arrangements to allow the investor to meet its reporting needs. Private fund advisers would face difficulties assessing whether customized reporting of portfolio holdings and exposures will run afoul of the "material, negative effect" standard set forth in the Proposed Rule, in particular as it applies to any investor in the fund. The Proposed Rule, however, would force advisers to choose between providing investors with the information required under applicable law or to reject their requests for admission to the fund.

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close to violating the plain language of the statute. At best it is counterintuitive to characterize the investors in a hedge fund as the 'clients' of the adviser.")

The Release cites a concern that preferential information could result in "front running" by investors; we would support adoption of a rule by the Commission that would ban front-running by investors, since currently advisers can only limit such activity through private contractual arrangements.

(b) ***Effecting*** *preferential rights rather than* **granting** *preferential rights*

The ability to redeem (or withdraw capital) from a private fund is more typical of open-end funds (*e.g.*, hedge funds) and hybrid funds (*e.g.*, closed-end funds that allow for limited but periodic redemption rights), than conventional closed-end funds wherein liquidity for investors is provided primarily through distributions from investment proceeds or through secondary transfers by an investor to another investor. An investor's right to redeem covers many aspects, including: (i) the minimum amount of time required to request a redemption (*e.g.*, notice and lock-up periods), (ii) the length of time by which redemption proceeds will be paid (in part or in full), (iii) limitations on redemption such as holdbacks, suspensions or gates, (iv) the ability to receive or be paid in cash or in-kind, and (v) clawbacks, if any. Any or all of these rights may be open to negotiation and modification with investors in a private fund, and advisers will typically determine whether or not any particular redemption right can be modified depending on various factors, including the portfolio's liquidity, anticipated portfolio management and other business concerns.

However, the Release expresses a concern that preferential redemption rights could harm the fund's investors if for example a preferred investor is permitted to exit early with the result that the fund must liquidate liquid positions to the detriment of the fund's remaining investors. These and other examples in the Release, however, identify situations which can only be evaluated at the time that the redemption right is effected, rather than when the right is granted. In an open-end fund that allows investors to enter and exit, the appropriate time for evaluating when a "preferential" redemption right may harm other investors should be when the right is exercised not when it is granted. Instead, because of the breadth of the proposed rule text, we believe that side letters or other ad hoc arrangements designed to accommodate investors would instead cease to be offered out of a concern that providing any rights would result in a *per se* violation under the Proposed Rule.

For example, if an adviser waives the minimum 60-day notice period or the lockup period for all investors seeking a redemption for the same date (a practice that occurred during the last financial crisis), then we do not believe that the Proposed Rule should be implicated. Similarly, certain investors (such as state governmental plans or ERISA plans) often cannot receive in-kind redemption proceeds for various regulatory reasons; fund documents often allow the adviser to liquidate such assets on behalf of all investors not just those subject to these regulatory restrictions. An investor however may be required to seek a side letter confirming that it is not required to accept in-kind proceeds. If the Proposed Rule were adopted, advisers would refrain from entering into side letters or granting an exception to a redemption policy, in part because the term "material negative effect" is vague.

Instead, if the Commission is concerned about "preferential" redemption rights whereby some investors could receive priority treatment ahead of others, the appropriate point in time would be when the adviser is required to satisfy an investor's redemption rights (*i.e.*, when the right granted to the investor is ***exercised***) rather than when the right is ***granted***. In other words, until the redemption right is exercised, it will be difficult to determine whether any "material, negative effect" on other fund investors could or would arise. An adviser should be permitted to grant a waiver of a lockup period for an investor, but unless and until such waiver is exercised or is exercised in an arbitrary manner (and evaluated under the totality of the facts and circumstances at that time), there should not be any rule violation.

For similar reasons, we believe that information rights granted to an investor should only be limited if they are used for purposes unrelated to monitoring an investor's investment in the fund. Preferential information coupled with enhanced liquidity could give rise to some of the issues identified by the Commission but such risk should be addressed through monitoring by the adviser at the relevant time, rather than an outright ban on providing information *per se*.

(c) The definition of "substantially similar pool of assets"

Although we understand that the purpose of this definition is to include parallel funds, including customized parallel funds, the definition of substantially similar pool of assets is overly broad. Because the definition uses the disjunctive "or" in identifying "substantially similar investment policies, objectives, ***or*** strategies" to that of the main private fund, it could be read to inadvertently include all funds that use a particular investment strategy, even if there are meaningfully different investment policies on such matters as diversification, concentration limits, or leverage. For example, an adviser may offer a longer-duration fund in a closed end format alongside an open end fund with more liquid positions—on a larger scale, certain large asset managers simultaneously raise dozens of "funds of one" and commingled funds with similar investment strategies, and treating those as "substantially similar" for purposes of this rule would upend those platforms. Investors would not view such investment funds as being comparable or even substantially similar, but the text of the Proposed Rule would treat them as "substantially similar" and thus the adviser would have a per se rule violation if it sought to offer a closed end fund alongside the open end fund, or a customized fund of one alongside either.[111]

Under the Proposed Rule, management of a "fund of one" on a side-by-side basis with a private fund could be substantially limited because such "fund of one" arrangements often entail customized reporting and liquidity provisions negotiated with the individual client that may be

[111] Indeed, because the definition makes no distinctions regarding the format and structure of a pooled investment vehicle, it is even possible that the term could include securitization structures that rely on Rule 3a-7 under the Investment Company Act or on Section 3(c)(5) when considered alongside a private fund that has a strategy to invest in similar types of assets (*e.g.*, a credit card receivables fund). We believe inclusion of such securitization structures in the scope of "substantially similar pool of assets" would be administratively difficult and of no utility to private fund investors given the completely dissimilar investment structures. Similarly, investment vehicles relying on other exclusions or exemptions under the Investment Company Act (*e.g.*, sections 3(c)(3), 3(c)(6), or 3(c)(11) or an employee securities company) or a commodity pool could fall within the definition of "substantially similar pool of assets." Given the different reporting requirements and liquidity terms of these different types of pooled investment vehicles and structures (*e.g.*, some 3(c)(11) funds provide daily valuations or even daily liquidity), inclusion of these other types of pooled investment vehicles within the scope of "substantially similar pool of assets" may result in *per se* violations of the Proposed Rule.

substantially different from those of the fund. Such arrangements are typically sought by many Specialized LPs in order to accommodate their particular regulatory and legal requirements.

We strongly urge the Commission to modify the definition of "substantially similar pool of assets" so it is limited only to those funds that invest side by side, *pari passu*, with the main fund, with respect to substantially all investment opportunities.

We also request that the Commission provide clarification with respect to the application of the Proposed Rule to funds of one. We note that the definition of "substantially similar pool of assets" is limited to a *pooled investment vehicle*. Accordingly, we request that the Commission confirm that the staff's existing guidance regarding "pooled investment vehicles" for purposes of Form ADV (indicating that single-investor funds and funds of one should not be treated as "pooled investment vehicles" for purposes of Item 5.D of Form ADV Part 1A under certain circumstances) would also apply to the definition of "substantially similar pool of assets." [112]

We also request that the Commission clarify that pooled vehicles that are not parallel partnerships/entities within the same "fund" will not be deemed to be "substantially similar pools" even if there is overlap between the pools in respect of their investment portfolios.

(d) Impact on certain methods of compensation and multi-class fund structures

We note that in some open-end fund structures, advisers and investors have agreed that advisers should be compensated in the form of issuing additional units of the fund, rather than through direct cash payment, for management fees or performance-based compensation, or both. Typically, these arrangements permit the adviser to redeem these units on a preferential basis—*e.g.*, by waiving lock-up periods and notice periods, and/or through an exemption from the "redemption queue." Such preferential redemption rights reflect the negotiation between the adviser and the fund's investors to allow the adviser to be paid in a timely manner, recognizing the fact that these units, when issued, generally evidence the adviser's share of positive performance over a prior look-back period (such as three years). We are concerned that these preferential redemption rights, even though limited to units issued as compensation, could be prohibited under the Proposed Rule, which would limit the ability of advisers and investors to agree on mutually beneficial, tax-efficient compensation arrangements.

Finally, we note that some funds are structured to provide investors with the option to participate in different classes of fund interests, coupling lower fees with longer holding periods, or higher fees with shorter holding periods. Some investors opt for the lower-fee arrangements in exchange for restricted liquidity and redemption rights within the same private fund, while other investors prefer to pay more in exchange for greater flexibility. This is no different from mutual funds offering investors different fee terms for differing holding periods, but the Proposed Rule does not make it clear that it is not intended to capture such a practice, although we believe that

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[112] *See* SEC, Form ADV and IARD Frequently Asked Questions, Form ADV: Item 5.D*, available at* https://www.sec.gov/divisions/investment/iard/iardfaq.shtml; *see also* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Release No. 3222 (June 22, 2011) at p. 78-79.

was not the Commission's intent. We urge the Commission to clarify, and to revise the Proposed Rule as necessary to make clear that fund terms disclosed to all investors directly in a fund's offering document or governing documents do not constitute preferential terms subject to proposed rule 211(h)(2)-3.

2. Disclosure of Preferential Terms

<u>*Pre-Closing Disclosure*</u>

The Proposed Rule would prohibit advisers from providing any other preferential treatment unless described specifically in disclosure to current and prospective investors ahead of the investment and on an annual basis thereafter. The Commission believes that such increased transparency would help investors shape the terms of their relationship with the adviser of the private fund.

We believe that this aspect of the Proposed Rule is also overly broad, and unduly burdensome, such that it could cause a significant decrease in the use of side letters altogether. Although that outcome, on its face, may initially seem to be beneficial to investors (and may in fact be the Commission's desired though unstated outcome), we believe this would ultimately be harmful to investors since it would preclude certain investors from participating in commingled funds and eliminate side letters or other arrangements as one of the primary methods by which investors shape their relationships with advisers in a manner that is most workable and capital efficient for them.[113]

First, the scope of the term "specific information" is vague and does not clarify the degree, scale or scope of the information that would satisfy this rule requirement. Second, the proposed rule text uses the term "preferential treatment" which suggests an objective standard but in reality ignores the totality of the facts and circumstances. Finally, the rule text uses the term "provide" in respect of preferential treatment to investors, which suggests an on-going temporal requirement that itself is unworkable.

As an example, we noted above advisers to an open end fund often use multi-class structures where investors have the option of investing in one class over another (*e.g.*, where the tradeoff is a longer lock-up period accompanied by a lower fee, relative to a shorter lockup period with a higher management fee). For closed end funds, investors who decide to invest early during the fundraising stage (or invest larger capital commitments) benefit from a lower management fee. Such fee discounts are typically disclosed to all investors through a fund's offering memorandum (including amendments thereto) and governing documents. This practice is already commonplace,

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[113] We note that based on the experiences of most members, the large, sophisticated investors that are most likely to have extensive side letter requests are also the investors most likely to provide the most comprehensive, substantive comments on fund governing documents, which benefits *all* fund investors. To the extent that the restrictions discussed in this section or elsewhere in this letter incentivize advisers and these sophisticated investors to opt for managed accounts or "funds of one" in lieu of a commingled product, those investors that do remain in private funds will no longer benefit from the critiques provided by these sophisticated investors and the resulting negotiations between them and fund advisers.

but the Release does not acknowledge this as an acceptable means of disclosure satisfying the rule requirement to provide "specific information."

Certain advisers could opt to disclose redacted agreements or distribute continuously changing lists of terms including technical provisions that are not of interest to most investors (*e.g.*, choice of law). The Proposed Rule could thus have the effect of making disclosure regarding preferential terms less meaningful.

The Proposed Rule text refers to "preferential treatment" and suggests that modifications to investor rights exist in isolation, and therefore fails to account for the totality of the terms and conditions that typically accompany any modified rights or additional rights that an investor may have. For example, a large pension plan or other retirement vehicle (*e.g.*, non-U.S. retirement funds) typically asks for the ability to transfer to an "affiliated" vehicle subject to various pre-conditions (*e.g.*, maintaining a significant stake in the fund, and remaining in good standing/not in default with respect to its obligations under the fund documents). However, not all investors are similarly situated, and we question the informational value to providing all such information to investors indiscriminately.

This issue is most apparent in cases involving "most favored nation" ("**MFN**") and other arrangements where private funds distinguish between investor rights, based on the category of investors. These investors include: investors who are affiliated with the private fund's adviser, investors who are subject to specific legal and regulatory requirements (*e.g.*, sovereign wealth funds and state governmental plans) and strategic investors whose rights are dictated by the their overall relationship with the adviser (across its entire platform of products and services). These categories of investors receive rights that are unique to their characteristics/attributes, and the rights that they receive are not comparable to the terms investors negotiate with respect to an investment in a single fund; these contractual arrangements may be incorporated within a fund or outside of a fund. For example, a fee discount arrangement may be designed to offset certain fee rebates which could have an adverse tax consequence to non-U.S. investors; offsets may also be provided to an adviser's advisory clients that invest in the adviser's funds to avoid or reduce the impact of paying multiple levels of fees. Similarly, strategic investors may be entitled to receive fee discounts across an adviser's platform of products, but such arrangements are contingent upon significant conditions and terms (such as minimum investment thresholds and extended investment periods) which would not apply to other investors in the same private fund. Moreover, disclosure of these terms or mechanics (*e.g.*, whether discounts or rebates are credited or offset within the fund or outside the fund) would require a description of the other investments that affect the fees and such description could violate confidentiality provisions, especially because in many cases, solely providing the fund-level terms could result in distorted and potentially materially misleading disclosure to other investors.[114]

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[114] By way of example, an adviser that invests an advisory client's assets in a fund managed by the adviser may offset 100% of the fund-level fees payable by the investor (and thus be solely compensated under the advisory agreement with the client). To the extent the fund's adviser was then required to disclose to other fund investors (who are not advisory clients of the adviser) that some investors pay no fees, such a disclosure would be completely inapposite and likely lead to additional confusion because the circumstances of the advisory client investors and non-client investors are not comparable.

Finally, a requirement to provide specific disclosure to all investors *prior* to their investment would significantly increase the burden on advisers, particularly those sponsors with numerous side letters, and is likely to cause significant delays to closings. The requirement would also drive up fund organizational costs, which are borne by investors (we do not believe that passing on those costs would run afoul of the prohibition on passing on certain compliance costs) and the legal bills of the investors themselves conducting a review of the prospective investment. Current market practice for closed-end funds, which often have a significant number of investors coming into the fund at multiple closings, is to provide all investors with general disclosure regarding the types of side letter terms that the adviser would agree to prior to investment, followed by providing investors with MFN treatment notice of the specific terms available to them *after* the final closing. A requirement to provide disclosure *prior* to investment would be administratively difficult to comply with for each closing and could re-open negotiations (or delay a closing due to the on-going need to negotiate or renegotiate terms), thus causing a fund to miss investment opportunities, and increase closing costs (which typically are borne by investors directly when they retain counsel or indirectly as a fund expense).

Hedge funds typically approach the MFN process differently, often limiting MFN election rights to a specific time period (*e.g.*, two to three years from the investor's closing), with the election period often synchronized to a corresponding lock-up period. The effect of the Proposed Rule would be to increase operational costs significantly for hedge fund advisers that permit side letters.

Thus, we urge the Commission to modify the Proposed Rule so that advisers are only required to provide disclosures regarding "preferential treatment" terms in effect as of the time immediately prior to an investment in the fund, and for funds that use an MFN, "preferential treatment" would not include terms that are excluded from the MFN election process because of the specific circumstances of the investor.

With respect to the notice requirement under the Proposed Rule, we request clarification that posting the requisite information to a virtual data room would satisfy the Proposed Rule. We view virtual data rooms as the equivalent of sending physical records to an investor, whereupon the obligation to open, review and understand the information is the responsibility of the recipient rather than the sender. Although footnote 99 of the Release recognizes that electronic delivery of documents would satisfy the "in writing" requirement, we urge the Commission to provide the same treatment to advisers of private funds that the Commission provides to advisers of mutual funds – who are permitted to post information to their websites and are only required to deliver physical records upon the affirmative election of the investor.[115] Such an approach would also recognize that investors increasingly rely on technologies for virtual data access, while enabling remote work for personnel at advisory firms during global health emergencies and otherwise and that such data sites often offer heightened data security protection compared to email distribution.

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[115] 17 C.F.R. § 270.30e-3(b)-(e).

Annual Disclosure

The Proposed Rule would require advisers to distribute on an annual basis to a current investor specific information regarding any preferential treatment to other investors. We re-iterate our concerns regarding this aspect of the Proposed Rule based on the considerations highlighted above in this section. To the extent that an adviser is subject to this requirement, we also urge the Commission to modify the Proposed Rule so that the adviser's obligation to "distribute" such information is satisfied if it is provided to an affiliated fund (*e.g.*, an access feeder fund) that is managed by an affiliated party. Currently, the Proposed Rule requires that the adviser "distribute" such information on a look-through basis; it would be impracticable for an adviser to do so for various confidentiality and privacy reasons. As noted above, this aspect of the Proposed Rule requires that an adviser "send" rather than make available such information to upper tier feeder funds managed by an affiliate even though the underlying fund's adviser has no information regarding such upper tier investors. This issue is particularly acute in the case of global financial services firms that enable investors to access their funds through their affiliated entities world-wide. An additional unintended consequence would be to require a U.S. based adviser to distribute preferential treatment information to the non-U.S. investors in non-U.S. funds that are managed by non-U.S. affiliates who themselves would be exempt from the requirements of the Proposed Rule.

Additional Considerations for CLOs

If CLOs were not excluded, we believe the Proposed Rule would disturb existing disclosure practices for bespoke agreements between managers and investors without any commensurate benefit for CLO investors. It is standard practice to disclose arrangements in which CLO managers agree to rebate some of their management fees to strategic investors in the CLO. Standard practice for CLO arrangers requires that counsel is required to provide negative assurance letters that the disclosures in CLO offering memoranda, including regarding side letters, do not contain material misstatements or omissions. Under current market practice, prospective CLO investors—who, as discussed in Section IV.B.1. above, are, in nearly all circumstances, QIBs when they are third-party U.S. investors—are always provided an opportunity to request more information when they are provided the disclosure regarding bespoke arrangements. Given the structures of CLOs and the investment needs and economic arrangements for note investors, we believe that a general obligation to provide more granular detail regarding side letter arrangements would be counterproductive; for example, the amount of management fees that a manager rebates to an investor has no impact on the costs to other investors with respect to the CLO's management fees. A chilling effect on management fee rebate arrangements could in fact lead to increased management fees and increased costs to all investors, which in turn will drive down the willingness of third-party investors to purchase the notes issued by the CLO.

C. Comments with respect to other requirements under the Proposed Rule

1. Mandatory Annual Audits

General

Proposed Rule 206(4)-10 would require RIAs to private funds generally to cause the private fund to undergo a financial statement audit meeting specified requirements at least annually and upon liquidation, and to distribute such audited financial statements to all of the private fund's investors.

We generally agree with the Commission that most RIAs to private funds that are subject to Rule 206(4)-2 (the "**Custody Rule**") because they have "custody" of the private fund's funds or securities opt to utilize the "audit exception" provided in rule 206(4)-2(b)(4) (the "**Audit Exception**"), which largely, though not entirely, contains similar requirements as proposed rule 206(4)-10. Given the slight differences between the requirements of the Audit Exception and proposed Rule 206(4)-10, we would strongly support a revision to the proposal providing that compliance with either rule would satisfy the other in order to avoid confusion, streamline operational requirements and mitigate the costs of complying with the Proposed Rule.

We also agree with the Commission's proposal to use a "prompt" standard for the required delivery of financial statements to investors, which we believe would provide greater flexibility for fund-of-fund arrangements and similar structures, as well as inadvertent delay (as the Commission staff has had to provide through separate guidance on the Custody Rule Audit Exception, since that rule does not provide such flexibility).

SPVs

As discussed in Section IV.B.2 above, we encourage the Commission to exclude most SPVs from the scope of the Proposed Rule, and we believe such exclusion is particularly merited with respect to the proposed audit requirement to avoid unnecessary expenses and potential investor confusion with respect to SPVs held by private funds subject to the Proposed Rule or RICs or business development companies regulated under the Investment Company Act. At a minimum, we strongly encourage the Commission to incorporate existing staff guidance on the Audit Exception and the Custody Rule more generally into proposed rule 206(4)-10. In particular, we believe it is important to clarify how the Proposed Rule would apply to SPVs used to hold underlying portfolio investments ("**Investment SPVs**"). As the Commission[116] and its staff[117] have acknowledged, advisers to pooled investment vehicles (including private funds) may from time to time use Investment SPVs to facilitate investments by those funds. Investment SPVs may themselves be "private funds," as defined, and thus potentially subject to proposed rule 206(4)-10. We believe requiring advisers to cause these Investment SPVs to prepare and distribute separate audited financial statements would, under most circumstances, result in these Investment SPVs

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[116] Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2968 (Dec. 30, 2009) at Section II.F, available at http://www.sec.gov/rules/final/2009/ia-2968.pdf.
[117] SEC, Division of Investment Management, IM Guidance Update 2014-07 (June 2014), *available at* https://www.sec.gov/investment/im-guidance-2014-07.pdf.

(and thus, indirectly, private fund investors) incurring significant additional costs without any material benefit to investors that indirectly hold interests in such Investment SPVs. We believe that investor protection concerns can be achieved by treating the assets of the Investment SPV as assets of the private fund that invested in the Investment SPV, as permitted under the Commission staff's existing guidance under the Custody Rule so long as the Investment SPV is not held by anyone other than the adviser, its related persons, and other pooled investment vehicle clients controlled or advised by the adviser or its related persons, including, without limitation, RICs, business development companies, and funds that rely on the exception from the definition of "investment company" provided in Section 3(c)(11) of the Investment Company Act.[118]

Private Funds Owned Solely by Related Persons

In response to the Commission's request for specific comments, we would strongly support narrowing the scope of the Proposed Rule so that it does not apply to private funds that are owned solely by the RIA's related persons. While such an approach would slightly expand the Commission staff's existing guidance under the Custody Rule as applied to certain controlling principals of an adviser,[119] we believe the same policy rationale should also generally apply to the adviser's affiliates and other personnel. At a minimum, we suggest that the Proposed Rule should not apply under circumstances where the independent verification and account statement delivery provisions of clauses (a)(2), (a)(3) and (a)(4) of the Custody Rule were not required under the prior Commission staff guidance, as a failure to do so would effectively render such guidance moot for private funds.

Issues Related to Non-US-Organized Funds

In addition, we suggest that proposed rule 206(4)-10(c) be modified to only require reconciliation to U.S. GAAP for private funds organized under non-U.S. law if the private fund has investors that are U.S. persons. We believe that such non-U.S. investors do not expect or desire such reconciliation to U.S. GAAP, and accordingly the requirement to perform reconciliation would result in increased expenses for these private funds without commensurate benefits.[120]

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[118] *Id.* In addition, we note that some Investment SPVs may not be considered "investment companies" for accounting purposes, and in a number of circumstances advisers do not maintain SPV books under the same accounting basis (i.e., carry value determined by equity method accounting instead of fair value). Consolidation could therefore require advisers to keep a second set of books and records under investment company accounting principles, which would ultimately increase investor expenses.

[119] *See* 16th Amendment Advisors LLC, SEC Staff No-Action Letter (March 23, 2015), *available at* https://www.sec.gov/divisions/investment/noaction/2015/16th-amendment-advisors-032315.htm.

[120] We note that based on existing Commission staff guidance, under certain circumstances, such a fund organized under non-U.S. law that has minimal contacts with the United States may not need to rely on the exceptions provided in Section 3(c)(1) or 3(c)(7) of the Investment Company Act. *See generally Goodwin, Proctor & Hoar*, SEC Staff No-Action Letter (Oct. 5, 1998); *Goodwin, Proctor & Hoar*, SEC Staff No-Action Letter (Feb. 28, 1997); and *Investment Funds Institute of Canada*, SEC Staff No-Action Letter (Feb. 6, 1996). We do not believe such funds, even if advised by an adviser with its principal office and place of business in the United States, would be subject to the Proposed Rule.

Furthermore, we would propose that private funds organized under non-U.S. law (regardless of the presence of investors who are U.S. persons) have the option of having the annual audit undertaken in accordance with internationally recognized Standards on Auditing (ISAs) rather than having to perform the audit in accordance with U.S. GAAS. In many non-U.S. jurisdictions, most notably the European Union, private funds are required to conduct an annual audit in accordance with ISAs which are broadly comparable to U.S. GAAS, but with different audit independence considerations. Because certain European Union-domiciled funds also need to rotate auditors every 10 years, we believe it will become very challenging to identify auditors that can issue audit opinions under both ISAs and US auditing standards, which we believe will be detrimental to investors from an auditor quality, selection and costs perspective.[121]

Stub Periods

The Commission also requested comment on whether proposed rule 206(4)-10 should be modified to allow newly formed or liquidating entities to obtain an audit less frequently than annually to avoid "stub period" audits. We commend the Commission for considering the issue, and urge the Commission to revise the Proposed Rule to address those situations. Our members have generally found that the expense associated with preparing audited financial statements is generally not proportionate to the length of the fiscal period in question, and accordingly, even under the Custody Rule, members are often required to prepare and distribute audited financial statements for newly organized funds for a stub period as short as a week or a few days—even if no capital has been called from investors and no fees have been paid to the fund's adviser—which presents a significant expense for a new fund without any material benefit to investors when such stub period could easily be incorporated into the fund's first full fiscal year. We would further urge the Commission to consider providing that rolling such stub periods forward into the fund's first full fiscal year would also be deemed to satisfy the Audit Exception under the Custody Rule. By the same token, as a private fund nears final liquidation, it is often the case that a fund's sole remaining assets will consist of amounts held in escrow, amounts retained as part of a litigation holdback, or similar small holdings. The cost of obtaining annual audited financial statements for such funds is often significantly out of proportion to the remaining value of assets in the fund. In order to comply with the Custody Rule's Audit Exception, some advisers have opted to restructure these funds as liquidating trusts or use other similar mechanisms in order to avoid "custody" of the fund's assets, and thus avoiding material additional expenses towards the end of a fund's life. We would fully support making any relief from these requirements conditioned upon obtaining the informed consent from the private fund's LPAC, independent directors, or similar governing body (or a vote of the private fund's investors, in the absence of such a governing body). We believe the interests of investors and fund advisers are fully aligned in this matter. We urge the

[121] We also request that the Commission clarify that no report to the Division of Examinations would be required pursuant to proposed rule 206(4)-10(e) (or the agreements entered into thereunder) where a private fund's independent public accountant resigns, is dismissed, or otherwise terminated, or removes itself or is removed from consideration for being reappointed because the adviser or the independent public accountant reasonably believe that (i) the independent public accountant does not or will not satisfy the independence standards set out in proposed rule 206(4)-10(a), or (ii) such resignation, dismissal, termination, or removal from consideration is required to comply with any auditing standards applicable to the fund (including, for the avoidance of doubt, rotation requirements under ISAs).

Commission to address this issue to reduce these unnecessary costs and preserve value for private fund investors.

Additional Considerations for CLOs

We also wanted to provide comments on one aspect of proposed rule 206(4)-10 that we believe the Commission did not fully consider as part of its Proposed Rule.

The Commission asks in the Release whether a rule with respect to audits should "provide any full or partial exceptions."[122] The Commission cites as an example a fund where the investment adviser plays no role in valuing the fund's assets.

While, as noted above, we agree that most private fund managers do already obtain and distribute audited financial statements for their funds in compliance with the Audit Exception, one major exception to this generalization relates to CLOs.

The Release states that the Commission believes an annual audit "would provide protection for the fund and its investors against the misappropriation of fund assets," and also "would provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees."[123] Generally, most CLOs are structured using an independent trustee who maintains control over the CLO's assets and payment of expenses with strict limits on the CLO manager's ability to access the assets of the CLO. Accordingly, we believe to the extent that CLO managers have concluded that they do not have "custody" under the Custody Rule, such CLO managers should not be subject to proposed rule 206(4)-10.

In addition, market value does not drive a CLO's manager's management fees. The "fee basis amount" for CLO management fees is based on the principal balance of the loans in the CLO portfolio, and sometimes also cash treated as "Principal Proceeds" in the CLO's accounts. Indeed, CLOs are generally cash flow-oriented vehicles that are not driven by the market value of assets. CLO managers are only required to calculate the market value of loans in CLO portfolios in limited instances, for example as a haircut amount for defaulted loans, and the calculation of market value in a CLO is carefully regulated in the CLO indenture, *e.g.*, requiring quotes on loans from a nationally recognized pricing service, or otherwise an average of bid-side quotes from independent broker-dealers if available, and only if these are unavailable, then a calculation of the lower of a rating agency-assigned recovery amount and a valuation by the CLO manager. Furthermore, the investors in a CLO are typically buy-to-hold investors. Unlike in other private funds, there is no mechanism in CLO transaction documentation in which investors would be able to choose to redeem their investments at a net asset value or market value.

In all events, as discussed below in Section V.C.3, CLO noteholders already receive detailed monthly reports as well as payment date reports, each prepared by an independent collateral administrator that is most often the bank that also acts as CLO trustee, providing

[122] Release at 115.
[123] Release at 99.

extensive information about the assets of the applicable CLO and the cashflows. The scope of reporting has been expanded over time in response to investor comment.

In the Release, the Commission concludes, seemingly without factual or logical support, that investors in securitized asset funds would be likely to benefit from the annual audits required by proposed rule 206(4)-10. In contrast with traditional private funds, based on the structure and economics of, and existing detailed reporting in, CLOs, we do not believe that investors in CLOs would generally stand to derive any benefit related to an auditor's review of the safekeeping of assets (which are already controlled by the trustee), or the valuation of assets. Investors would simply incur additional costs with no attendant benefit. The Commission's policy goals with respect to transparency are already realized in CLOs through existing detailed monthly and payment date reporting.

2. Mandatory Fairness Opinion in Adviser-Led Secondaries

<u>General</u>

Proposed rule 211(h)(2)-2 appears to be targeted at adviser-led secondaries involving continuation funds or similar structures, whereby investors in a closed ended fund are able to obtain liquidity by "rolling" their interests into a new fund. Many advisers initiating these types of adviser-led secondary transactions currently obtain fairness opinions as a matter of best practice, especially when the underlying assets that are part of the adviser-led secondary transaction involve illiquid or difficult to value portfolio investments.

However, as drafted, the Proposed Rule could capture other types of transactions that would not give rise to the same types of concerns raised by the Commission in citing continuation funds, such as:

- A rebalancing of portfolio assets between or among funds that include open-ended and closed-ended funds.

- The opportunity to reinvest redemption proceeds (whether received in connection with a redemption or a fund liquidation) in another private fund, whether open-ended or closed ended.

- A transfer of assets (*e.g.*, a distribution in kind) from a private fund to another private fund that is wholly owned by the same investor.

- The exercise of a "right of first offer" by an investor.

- Transactions involving an auction or competitive bidding process.

- Ordinary course transfers between one fund into another related fund (*e.g.*, two-step transfer from one feeder fund to another feeder fund for an investor or its estate planning entities).

- Transfers offered through secondary liquidity platforms sponsored by advisers or their affiliates.

In each of the above scenarios, the transactions (i) already provide for valuation by an independent third party, typically the fund's custodian or administrator who is responsible for valuing a fund's assets, and in the case of a liquidating fund would also involve a final or liquidating audit by the fund's auditor, (ii) permit an investor to hold assets directly rather than indirectly (*i.e.*, the distribution in kind situation) or (iii) facilitate or accommodate investor requests as in the case of a transfer from one feeder fund to another in order to allow a transfer from a taxable individual to his/her/its family trust which would be non-taxable. Although the listed types of transactions occur on an ad-hoc basis (such as when a fund is terminated or makes an in-kind distribution), requiring an adviser to obtain a fairness opinion for these types of transaction would not provide a meaningful benefit to investors since an independent party is already valuing the interests to be redeemed or rolled over (or alternatively the transaction involves the same fund complex). Moreover, to accommodate investors seeking liquidity, certain advisers have developed or are developing secondary liquidity platforms, which effectively match a potential seller with a potential buyer. As defined, the term "adviser led secondary" could effectively preclude such platforms, because the adviser could be deemed to have "initiated" such transactions allowing an investor to "sell all or a portion" of its interests in the private fund, even though no adviser or related person is involved in the transaction other than as the platform provider (akin to an electronic bulletin board), with no ability (or need, from the investors' perspective) to procure a fairness opinion.

Indeed, adopting the Proposed Rule would more likely result in advisers ceasing to offer these opportunities to investors at all, due to the additional cost of obtaining a fairness opinion. Therefore, we urge the Commission to modify the Proposed Rule so that it would exclude the types of transactions described above, all of which are aimed at increasing capital formation, facilitating investor liquidity and contributing to efficient markets. For the same reasons, we also urge the Commission to consider narrowing the definition of related person as it relates to this aspect of the Proposed Rule. As proposed, the Proposed Rule would require a fairness opinion even if an adviser permitted an investor to contribute fund interests to another fund that is managed by a related person that is operationally independent of the first adviser (or otherwise is subject to an information wall). (Our concerns are on the applicability of this aspect of the Proposed Rule is discussed above in Section IV.C.)

The Release also solicits comments on whether advisers should actually be prohibited from using an opinion provider that has served as prime broker, auditor, or placement agent, or has provided investment banking services. We urge the Commission not to adopt such a prohibition. We believe such a prohibition would be a departure from market practice, and would impose significant burdens on advisers and potentially result in lower quality fairness opinions for investors (particularly in niche specialty areas where they may be only a few sophisticated opinion providers, all of whom may have material business relationships with a fund adviser that is active in the asset class).

Additional Considerations for CLOs

In the context of CLOs, it is not clear which types of transactions would constitute an "adviser-led secondary transaction." The Commission asks whether certain adviser-led secondary transactions should be exempt from a rule requiring fairness opinions.[124] We urge the Commission to narrow the definition of adviser-led secondary transaction to make clear that common CLO transactions are excluded, such as the following: (i) re-issue transactions (*i.e.*, "call and roll" transactions); (ii) issuer repurchase of notes; (iii) re-pricings; and (iv) re-financings. In addition, we urge the Commission to make clear that an exchange or conversion of first-loss interests in a warehouse facility into equity instruments in the related CLO does not constitute an "adviser-led secondary" transaction.

A "call-and-roll" transaction is a transaction in which the debt of a CLO (*i.e.*, generally, the outstanding notes) is redeemed through a sale of the portfolio to a newly organized CLO, and investors in the equity instruments in the redeeming CLO acquire the equity instruments in the new CLO. These transactions always require the consent of the equity investors; it is standard for the redemption to require the consent of the equity investors, and these equity investors are provided equity instruments in the new CLO, rather than cash, at their election. We believe the market for these types of transactions is well functioning. In all cases, the investor protections in CLO documents with respect to these types of transactions are time-tested. A regulatory requirement of a fairness opinion would simply introduce unnecessary cost that would be borne entirely by the equity investors (as noteholders would be fully repaid when the notes are called).

If the Commission determines not to exempt CLOs from the rule relating to adviser-led secondary transactions, we request that the rule only apply to CLO re-issue transactions, and that in lieu of a fairness opinion, the investment adviser would be required to provide to investors the proposed prices at which loans would be sold from the existing CLO to the new CLO.

3. Quarterly Statements

General

While recognizing the Commission's goal to codify reporting practices for private fund investors — and supporting the general goal of increasing transparency — we have significant concerns with the Proposed Rule's requirements related to private fund quarterly statements. Similar to other portions of the Proposed Rule, the quarterly statements requirements (as currently proposed) are overly broad and not proportionately targeted to the existing needs of private fund investors, thereby undermining the promotion of efficiency, competition and capital formation. The Proposed Rule will significantly increase regulatory and compliance costs for private funds and their registered investment advisers, and as further explained below, the added reporting requirements are unlikely to benefit the types of investors that traditionally invest in private funds. This undermines the goals the Commission should take into consideration under Section 202(c) of the Advisers Act.

[124] Release at 127.

While the Advisers Act does not currently require investment advisers to provide reports or statements to their advisory clients, the private funds industry (and the CLO market)[125] already provide extensive disclosures and reporting to investors. Private fund reporting generally includes (but is not limited to) information regarding a private fund's portfolio holdings, performance and financial information (including fees),[126] and the information is provided to investors both on an ad hoc and/or periodic basis (*e.g.*, quarterly and annual basis). As discussed in Section V.C.1 above, many private funds also distribute audited financial statements to their investors. Additionally, many investors have already developed and negotiated customized reporting with private fund advisers, particularly state and municipal pension plans that invest in private funds, a specific category of investors that the Commission has emphasized as part of its basis for implementing the requirements under the Proposed Rule.[127] Those investors also often are required to comply with state or municipal reporting requirements and make "FOIA"-like disclosures, which typically require private funds and their advisers to make specialized reporting available to them.

The proposed quarterly statements requirements thus do not take into account the existing reporting practices within the private funds industry and fails to consider the benefits most investors in private funds would see from the new requirements as measured against the added burdens and costs to both advisers and investors themselves. The Commission recognized in the Release that costs for funds and investors are increasing, but this aspect of the Proposed Rule related to quarterly statements would directly increase those costs dramatically. For example, advisers would often have to duplicate internal books and records to create parallel accounting processes and books solely to meet the reporting requirements based on the new requirements, as well as maintain accounting processes to meet the fund's existing internal reporting requirements, agreed to and expected by the private fund's investors. The proposed requirements may be of limited value to assorted types of private fund investors given the existing reporting already done within the private funds industry and the associated higher costs for compliance with the new requirements, which would likely be passed on to such investors directly as higher fund expenses or indirectly through higher advisory fees or administration fees.[128] We estimate those costs would result in a doubling of an adviser's internal fund accounting headcount or in a doubling of third party administrator fees.[129] As stated previously, the additional operational and compliance costs associated with the Proposed Rule's requirements may likely prove significant to smaller, start-up and emerging private fund advisers, who may decide to exit or forgo entering into the private fund space, resulting in less investor choice, diversity and competition within the industry.

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[125] Most CLOs generally require quarterly reports, which typically are provided by a collateral administrator independent of the CLO manager on every quarterly payment date. In addition and with respect to many CLOs, the collateral administrator typically produces a report every month, reporting on a host of items relating to the assets, and portfolio quality tests related thereto.

[126] With respect to CLOs, many CLO expenses (including management fees) are agreed at the outset of a CLO and such management fee compensation is disclosed to investors in the CLO's offering document.

[127] Release at 8.

[128] We believe that many private fund advisers may decide to outsource these reporting responsibilities to a third party administrator, leading to higher fund expenses that are passed on to investors.

[129] This data has been provided by certain of our members to provide the Commission with a sense of the order of magnitude of this aspect of the Proposed Rule.

Moreover, the Release justifies the need for quarterly reporting to help inform investors whether to "remain invested" in the fund. However, the Release fails to take into account whether a quarterly reporting requirement would be beneficial to investors in a closed-ended fund where redemptions are generally not permitted except in rare circumstances such as to comply with applicable law (as discussed above). A final rule should reflect that for investors in such funds, annual reporting rather than quarterly reporting, if any, should suffice. The Release also fails to acknowledge that if such reporting is meant to help with these types of determinations, then it may in fact be functioning as an "advertisement" that must meet the requirements and observe the prohibitions of the new Marketing Rule. We would accordingly urge the Commission to confirm that these reports would be excluded from the definition of "advertisement" pursuant to Rule 206(4)-1(e)(1)(i)(B), which excludes "information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication."

Furthermore, we are concerned that disclosing the information required by the Proposed Rule could result in broad dissemination of material non-public information (*e.g.*, a portfolio company may be paying fees to a "related person" in connection with contemplating a potential transaction). In this case, it would be difficult to restrict investor access or monitor for compliance, and could impede regulatory efforts to contain use of MNPI in impermissible trading. Without the Proposed Rule, a portfolio company generally would be under no obligation to disclose transactions that are being contemplated or evaluated, only transactions that have closed or announced. Premature disclosure of such sensitive information could disrupt markets as well as potentially impede the ability of potential transaction to be consummated. Moreover, any information regarding compensation paid to related persons may be proprietary, confidential or competitively sensitive information that could be used by competitors to harm the business of an adviser or its related persons.

Instead of the proposed quarterly statements requirements, the Commission should consider a principles-based approach that is consistent with prior Advisers Act rulemaking, which satisfies the Commission's goals for investor transparency while at the same time granting advisers flexibility to implement reporting practices that are better tailored to the investors being targeted by the regulation and aligns with the audited financial statements already produced and distributed by most funds.[130] Moreover, greater flexibility will enable managers to design reporting information that is most meaningful to the fund's investors in light of each fund's respective investment strategy, asset class and investor profile. Given the above and the operational challenges and expenses associated with gathering the proposed granular level of data, we are also proposing certain revisions and highlighting specific considerations that the Commission should evaluate with respect to the quarterly statements requirement as further discussed below. These

[130] *See, e.g.,* Rule 206(4)-1(d)(2) of the Marketing Rule, which declines to impose the standardized reporting requirements with respect to the performance advertisements of private funds. We note that the Proposed Rule institutes this requirement in the quarterly statements' performance reporting requirements. While conceding that quarterly statement information likely is not an "advertisement" under the Marketing Rule, the imposition of standardized reporting requirements with respect to quarterly statements appears to contradict the more flexible approach under the Marketing Rule, which declined to impose such requirement for private fund advertisements following recognition of issues presented during the comment period.

are in addition to our prior commentary in Section IV.B urging the Commission to exclude certain private funds from the Proposed Rule (including certain SPVs and CLOs) as well as for the Commission to narrowly tailor the definition of related person (see also discussion on related persons below). We believe that the Commission's inclusion of these revisions would better tailor the scope and feasibility of the quarterly statement requirement while at the same time addressing the Commission's policy concerns with respect to private fund disclosures.

Additional Considerations for CLOs

We believe that the current CLO reporting regime adds further justification to our request that the Commission exclude certain CLOs from the Proposed Rule, including the quarterly statements requirement. CLO noteholders already have transparency into their investment in the respective CLOs in which they invest. CLO investors typically receive very detailed monthly reports from the CLO's independent collateral administrator (such reports, the "**Collateral Administrator Reports**") which contain, among other information, a CLO's portfolio composition, market value and characteristics of the loans in the portfolio, purchases and sales, balances and reconciliation of accounts, details of adherence or breaches of underlying portfolio investment constraints and distributions due to investors on a payment date. Prior to investing in a CLO, prospective CLO noteholders typically review the draft CLO transaction documentation and negotiate with the underwriter for additional stipulations, which often include additional information which the CLO noteholders would require to be reflected in the Collateral Administrator Reports. The Collateral Administrator Reports are also provided to external providers of cash flow modelling systems (such as Intex, Bloomberg, Moody's Analytics, etc.), which incorporate loan level and structural information related to the CLO. Alongside the Collateral Administrator Reports, most CLO noteholders also subscribe to a cash flow modelling system (that would be most suited to their needs) to analyze the underlying loan portfolio, structure and development of the CLO over time. The CLO noteholders – both the holders of debt instruments, and the holders of equity – are also able to analyze projected cash flows under various scenarios to determine future payment profiles and the circumstances in which structural enhancements will be triggered. All but the most junior tranche of notes in the CLO are rated by external rating agencies that also run stress tests under various scenarios and publish the results of these stresses relative to the current rating requirements of the notes.

The Commission asks whether it should exclude certain types of private funds from the proposed new quarterly-statement requirements, and raises as an example private fund "that only hold (or primarily hold) publicly traded securities, such as hedge funds"[131] We agree. Moreover, while corporate loans are generally not considered securities for purposes of the Securities Act of 1933, and corporate loans are not traded on exchanges, CLOs follow the Commission's example as far as private funds that should be excluded from the proposed new quarterly-statement requirement. As indicated above, CLOs are, based on rating agency requirements and otherwise, broadly diversified portfolios of small pieces of widely traded corporate loans of relatively large obligors, holding loans in respect of 250 to 500 borrower companies. The relatively small loan positions of CLOs are akin to the publicly traded securities the Commission refers to in inquiring about whether certain types of funds should be excluded from the quarterly statement

[131] Release at 51.

requirements. Neither CLO managers nor CLOs have controlling interests in the relative large companies that are the borrowers in respect of the loans in CLO portfolios.

The proposed additional reporting requirements would be more relevant to investors in other types of private funds (that are not CLOs), but would be an added cost to the CLO that ultimately gets passed down to the CLO investors, if through no other means than through increased management fees.

(i) Quarterly Statements – Timing and Scope

Aside from concerns with respect to its overall scope and need, we also have a number of specific operational concerns with respect to the Proposed Rule's quarterly statements requirement. As a general matter, the quarterly statements requirement would result in an obligation for advisers to provide **more** information in **greater** detail on a more **accelerated** basis to private fund investors than is currently required for investors in mutual funds. In fact, the Proposed Rule appears in certain cases to require more detailed reporting and stricter reporting deadlines with respect to private funds than those imposed on registered mutual funds – which we have summarized in Appendix D.

In brief, we note that:

(i) the 45-day reporting period is shorter than similar reporting requirements imposed on mutual funds, which generally have reporting deadlines ranging from 60 to 120 days;[132]

(ii) fee and other information provided in mutual fund prospectuses is generally updated annually (absent material changes) while a mutual fund's semi-annual and annual shareholder reports (which contain financial, performance and portfolio holdings information) are provided to mutual fund investors bi-annually and within 60 days after the relevant reporting period;[133]

(iii) in contrast to the line item disclosures under the Proposed Rule's Fund Table, the Fee Table in mutual fund prospectuses generally categorizes key fund expense information into three main categories (advisory fees, distribution fees and other expenses) followed by a total annual fund operating expenses figure;[134]

[132] *See* Rule 30e-1 under the Investment Company Act (establishing a 60 day deadline for the transmission of annual and semi-annual reports to mutual fund shareholders) and Rule 8b-16 under the Investment Company Act (stating that management RIC prospectuses have to be updated within 120 days of the fund's fiscal year end). *See also* Instruction A to Form N-PORT (establishes a 60 day deadline for quarterly N-PORT filings).

[133] *See* Section 30(e) of the Investment Company Act; Rule 30e-1 under the Investment Company Act (transmission of report to shareholders).

[134] For example, Form N-1A's fee table in Item 3 generally lists three categories within the annual fund operating expenses table included in a mutual fund's summary prospectus: management fees, distribution (and/or service fees) and other expenses, followed by total annual fund operating expenses. Mutual funds express such costs as a percentage

(iv) there is no comparable requirement for consolidated reporting for mutual funds, whereas the Proposed Rule would require advisers to provide consolidated reporting of fees and compensation for a private fund together with a substantially similar pool of assets; and

(v) under certain conditions, mutual funds can rely on a more flexible "notice and access" process with respect to electronic delivery of shareholder reports.[135]

This approach contrasts with the traditional approach of the Commission and the federal securities laws that recognized that financially sophisticated investors with more resources to evaluate investment decisions do not require the same amount of investor protection as those of retail investors.[136] Reporting by advisers reflects not only the sophisticated investor base (who often request bespoke reports) but also the diverse investment programs of private funds, which can range from high turnover public equities focused funds to highly illiquid funds that invest in middle market debt instruments. An unintended consequence of the Proposed Rule will be that many advisers will be unable to provide the reports within the 45-day deadline if they invest in more complex and less liquid portfolio investments.

Gathering the necessary fee, expense and performance information for private fund portfolio investments generally requires such fund advisers to compile data across a number of disparate assets, managers (in certain cases), and other inputs, which would necessitate a time period that is more flexible and longer than the proposed 45-day deadline in order to ensure that the information is presented accurately and completely. For example, illiquid funds that pursue private equity, value-add, structured credit and opportunistic real estate or venture capital strategies will likely face difficulties obtaining the necessary reporting information for their portfolio investments and estimating the unrealized portions of their portfolio within the strict 45 day deadline—and indeed, credit funds, CLOs or funds with non-control positions may be unable to obtain some of this information from their portfolio investments at all or within the proposed timeframe. Certain illiquid investments also may not crystallize compensation until the occurrence of specific events, which may occur after the proposed reporting deadline and would present significant challenges on the part of RIAs to report such information to investors in a meaningful and accurate fashion within the strict time limit.

In addition, other private funds, such as those structured as fund-of-funds, often need additional time and resources to obtain reporting information with respect to underlying portfolio investments. Certain of our members note that their fund of funds typically rely on reporting and valuations received from underling third party fund sponsors in order to value their own fund-of-fund portfolios. As such, fund-of-funds require more time than the proposed 45 day requirement in order to make accurate and fair current valuations of their fund-of-funds in a manner consistent with fair valuation standards. Imposing a "one-size-fits-all" deadline for private funds (not taking

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of investment value and have the *option* (but are not required to) subdivide the other expenses category into a maximum of three subcategories. See Instructions to Item 3, Form N-1A.

[135] Rule 30e-3 under the Investment Company Act.

[136] *See, e.g.,* 2019 Fiduciary Interpretation at 25-26.

into account the feasibility challenges of obtaining underlying information in a timely manner) would require funds-of-funds to choose between incurring potentially significant costs to increase headcount and resources in a good faith effort to meet such an expedited timeline, with minimal time to confirm and review such data, on the one hand, or reporting to investors on a quarterly lag, on the other. This would be a departure from the SEC staff's existing guidance under the Custody Rule, which permits fund-of-funds to deliver audited financial statements to investors within 180 days (or, in some cases, 260 days) of the private fund's fiscal year end.[137] In light of these challenges, the Commission should consider adopting extended deadlines for fund-of-funds that are similar to those permitted under the Custody Rule guidance. The Proposed Rule also does not include an exception for the report to be delivered after a fund's fourth fiscal quarter. It is routinely the case that fund advisers and investors agree that requiring a separate, unaudited report on a fund's fourth fiscal quarter is unnecessary and duplicative given that it would be followed on a later date by the mandatory audited annual report. For this reason, we urge the Commission to provide an exception from this requirement for the fourth fiscal quarter of any private fund subject to Rule 206(4)-10.

The Proposed Rule also sets a more restrictive timeline than most sophisticated investors themselves generally request in the first instance of an onboarding negotiation, and shorter than the expected reporting periods suggested by the Institutional Limited Partner Association (ILPA)'s Quarterly Reporting Standards. For example, funds are generally allowed 90 days for quarterly reporting and 120 days for annual audited reports, which are, in each case, typically, further subject to a "commercially reasonable efforts" standard, acknowledging the reality that forces outside of a fund adviser's control may make it impractical or impossible to deliver accurate reports within stated deadlines and that investors do not want advisers jumping through unreasonable hoops or incurring undue cost to meet them.

Imposing such a strict deadline would lead to higher compliance costs necessary to devote the required resources to marshal such information within the stricter deadline and could potentially increase the risk of inadvertent reporting errors by RIAs that undertake a good faith effort to prepare and distribute such information under the proposed tight timeline. Certain of our members also note that their administrative and internal accounting staff often require additional time to finalize private fund accounting information in the case of the annual audits of private funds, which are not finalized until well after the proposed 45 day deadline. Given the associated costs and risks, this strict 45-day quarterly reporting requirement may be of little benefit to most sophisticated private fund investors who may not expect or require such information to be delivered within such timeframe. Such an accelerated timeframe may also dramatically increase the risk of errors or misstatements in these quarterly reports, or necessitate the use of estimates or incomplete information, all of which is likely to further limit the utility and reliability of these reports for investors.

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[137] See ABA Committee on Private Investment Entities, SEC Staff No-Action Letter (Aug. 10, 2006), Staff Responses to Questions About the Custody Rule, Questions VI.7 and 8, *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm. *See also* Release at 108 (discussing this issue with respect to the proposed annual audited financial statement delivery requirement, which uses a "prompt" requirement).

For the reasons discussed above, we urge the Commission to remove the quarterly statements requirement. If the quarterly statements requirement is adopted, we urge the Commission to modify the Proposed Rule so that reporting (i) is only required on an annual basis within 120 days of the fund's fiscal year end (or longer, as permitted under existing Custody Rule guidance), (ii) is no more detailed than is required currently for mutual funds, (iii) is aligned with requirements for audited financial statements (as GAAP is the best way to ensure consistent across funds) and (iv) removes the consolidated reporting requirement.

(ii) Quarterly Statements – Fund-Level Disclosure

Proposed Rule 211(h)(1)-(2)(b) generally requires that advisers to private funds to report (before and after application of any offsets, rebates or waivers) detailed information on (i) fees and other performance compensation **paid to** an adviser or a related person and (ii) all other fees and expenses **paid by** the private fund not otherwise covered by clause (i) above, with separate line items for each category of fee or expense. The Commission's stated rationale for this aspect of the Proposed Rule was to provide investors with greater information regarding the types of compensation received by the adviser and its related persons in connection with managing the private fund.

For the reasons discussed above, we believe that this information should be provided on an annual basis within 120 days of fiscal year end rather than quarterly and should not be more burdensome than is currently required of mutual funds. Moreover, we believe that information regarding compensation to an adviser's related persons should exclude the categories of related persons for the reasons discussed above in Section IV.C, and further urge the Commission to clarify that disclosures of compensation paid to related persons would not require disclosure of actual amounts paid to individual officers and employees of an adviser (who may receive a share of the carried interest[138]). Finally, we believe that only expenses that arise to the level of "materiality" as understood under U.S. GAAP should be required to be provided as a separate line item expense. Switching to an annual reporting requirement (rather than quarterly) would reduce costs and will likely be more informative to most private fund investors, particularly for illiquid funds that do not have a need to prepare mid-year valuations.

Quarterly Statements – Covered Portfolio Investments

Proposed Rule 211(h)(1)-(2)(c) would require private fund advisers to disclose with respect to each covered portfolio investment (i) all portfolio investment compensation allocated or paid to the adviser or its related persons and (ii) the fund's ownership of each such covered portfolio investment as of the end of the reporting period. We have a number of concerns with respect to this aspect of the Proposed Rule, in particular its breadth and thus potential to include structures and relationships that imply the existence of a potential conflict when none exists. We believe that information regarding covered portfolio investments should exclude compensation or ownership

[138] We do not believe that requiring disclosure of such individuals' compensation arrangements was intended by the Commission, but could be viewed as required because such individuals are "related persons." We do not dispute that direct compensation arrangements between a fund and an employed individual would be disclosed, but we believe an adviser's internal compensation arrangements with personnel are highly sensitive for both advisers and their personnel.

to the extent paid to or covering related persons if such related persons fit within the categories identified in Section IV.C, for the same reasons cited therein.

As we discussed above in Section IV.D, we urge the Commission to clarify that for purposes of the definition of "portfolio investment compensation," compensation will only be viewed as "attributable to" the private fund's investment where (i) the adviser (A) controls, or has material influence over, the portfolio investment's decision to hire, retain or fire related persons, or (B) is not recused or removed from decisions involving the hiring, retention or removal of related persons, or (ii) the retention of the adviser or related person is a condition of the private fund's investment in the portfolio investment.

We believe that, absent this clarification, gathering the required, detailed covered portfolio investment information would materially increase compliance burdens and costs to produce such information in adherence with the proposed timing and content requirements, without a corresponding material benefit to the sophisticated and institutional investors who would receive such information. Compensation arrangements involving a conflict of interest implicated through covered portfolio investments are required to be fully disclosed to private fund investors pursuant to the adviser's fiduciary duty to the fund and are generally done so within the fund's offering memorandum, its governing documents or through other documented means. In addition, the proposed requirements do not provide clear exceptions for certain circumstances that may mitigate potential or actual conflicts of interests associated with covered portfolio investments. For example, the Commission should consider exempting disclosures for situations where the underlying portfolio investments are not controlled by the RIA (with "control" being the same definition utilized under Form ADV). In addition and as previously discussed in Section IV.C, the Commission should also consider narrowly tailoring the definition of "related person" under the Proposed Rule to exclude (i) any affiliates that are operated independently of the adviser from the scope of the Proposed Rule, (ii) any affiliates that are separated via information barriers or similar compliance policies and procedures, (iii) other private funds affiliated with the adviser and (iv) any affiliates operating pursuant to the *Unibanco* line of no-action letters. Many RIAs are subsidiaries of larger financial service companies but operate independently from their parent company and affiliates under common control through their parent company. Such RIAs are in many cases unaware of, or have information barriers in place with respect to, the activities of their common control affiliates, which would mitigate or not materially implicate conflict of interest concerns associated with covered portfolio investments.

Notwithstanding these more general concerns, we also urge the Commission to take steps to simplify and streamline certain of the required disclosures to make them more meaningful to investors. We suggest that portfolio investment compensation should only be set out on a "net" basis, after application of any management fee or other offsets, rebates or waivers. We believe that the proposed requirement to present such information both before and after application of these offsets is unnecessary, as the "net" figure is the more meaningful data point for investors to consider. We also suggest that portfolio investment compensation be provided on an aggregate basis, rather than for each individual portfolio investment. We believe that this aggregate reporting will achieve the Commission's policy objectives of providing transparency into certain fees paid to advisers and their affiliates while reducing the administrative burden on advisers. We also request that in the case of a portfolio investment in the form of debt or preferred equity treated as debt for tax purposes, the requirement to disclose the fund's "ownership percentage" of a covered portfolio investment be revised to permit disclosure of the principal amount of the debt or preferred equity, as applicable.[139] Furthermore, we request clarification that with respect to portfolio investments in the form of equity (other than preferred equity treated as debt for tax purposes, as noted in the preceding sentence), the requirement to disclose the fund's "ownership percentage" of a covered portfolio investment should expressly permit the adviser to base reporting on the information most recently available to it, as the adviser might otherwise be required to confirm information with the portfolio company on a quarterly basis, which could prove administratively difficult if the fund is not a controlling or majority owner of the portfolio investment.

Lastly, the Commission should provide clarification to the extent related party (and other) compensation information is broken into separate line item categories within a quarterly statement's fee table. Because a related party includes a broad swath of entities and personnel, which would include individual advisory employees, the "detailed" accounting requirement could potentially be interpreted as requiring the disclosure of individual employee compensation amounts. As noted above with respect to fund-level disclosures, we do not believe investor interests would be served by requiring fund advisers to disclose their compensation arrangements with specific personnel.

Performance Reporting Requirements

As noted above, we believe that proposed rule 211(h)(1)-(2)(e) should not rely on newly developed definitions of liquid fund and illiquid fund, and should instead use the defined terms set forth in Form ADV/PF for hedge fund and private equity fund. We believe that this approach would more accurately capture the types of funds for which the reporting requirements would be more appropriate. In particular, we are concerned that many hybrid funds would be treated as liquid funds and thereby be required to provide reporting that is not meaningful to investors. For example, some closed ended funds allow for periodic liquidity including through the admission of new investors or through limited redemption rights, and as a result my in the ordinary course acquire marketed traded securities in order to satisfy such liquidity options. We highlight this example because the definition of illiquid fund is defined using the conjunctive "and" (which means that a private fund must satisfy all conditions in order to be treated as an illiquid fund).

In addition, we are concerned that CLOs would be required to provide unnecessary reporting – reporting beyond the very detailed monthly and quarterly reports currently provided by CLOs to noteholders. We are not aware of CLO investors requesting additional reporting of this type in the current market.

[139] We note that, as discussed in the paragraph immediately above, we believe there should only be limited circumstances where a portfolio investment in the form of debt should give rise to "portfolio investment compensation."

If the Commission determines to adopt these definitions in the final rule rather than rely on existing definitions, we request that the Commission clarify the following elements in the definition of illiquid fund:

(i) the requirement for limited (*i.e.*, non-continuous) fundraising applies only to funds that engage in a finite period of fundraising (even if such fundraising occurs once every several years);[140]

(ii) the requirement that the fund not provide redemption rights[141] (or withdrawal rights)[142] excludes situations whereby investors (such as Specialized LPs) may seek redemption rights in order to comply with applicable law, regulation or policies or to avoid an adverse effect on the fund; and

(iii) that the requirement to invest routinely in illiquid or private securities does not apply to non-material investments in liquid assets (*e.g.*, 20% or less).[143]

Liquid Funds – Annualized and Cumulative Returns

With respect to the Proposed Rule's requirements for liquid funds to show both annualized *and* cumulative net performance, we request that the Commission re-evaluate this requirement and grant private funds flexibility in providing either annualized or cumulative net performance. Reporting to private fund investors typically utilize annualized returns, which is the approach also utilized by the Commission as part of the recent Marketing Rule's performance reporting requirements.

Illiquid Funds – Realized and Unrealized Performance

Because many private funds invest in highly illiquid assets, we believe that performance information should only be provided annually, rather than quarterly. Imposing frequent valuation and calculations of this nature on advisers would be highly burdensome and is more likely to result incomplete information especially during the early stages of a fund's ramp-up in its investment program. Gross/net IRR and gross/net MOIC information is more helpful after the fund's capital is fully deployed so that investors can see a fuller picture, rather than an incomplete picture, of the potential return profile of the fund.

[140] See definition of illiquid fund condition (ii): "does not continuously raise capital."
[141] See definition of illiquid fund condition (iii): "is not required to redeem interests upon an investor's request."
[142] See definition of illiquid fund condition (iv): "has limited opportunities, if any, for investors to withdraw before termination of the fund."
[143] See definition of illiquid fund condition (v): "does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments." We use the 20% threshold because it is used in the definition of a "venture capital fund" (see rule 203(l)-1 under the Advisers Act). See *infra* n.53.

Net of Subscription Line Financing for Illiquid Funds

Requiring advisers to private funds to calculate performance information net of fund-level subscription facilities would be challenging and potentially overly burdensome. Private fund advisers would have to tabulate and maintain records for two sets of performance returns on parallel paths (with and without the impact of subscription lines) solely for purposes of making this disclosure. In addition, it is unclear how the requirement should be applied in the case of funds-of-funds, and whether the net of fund-level subscription facility performance requirement applies at both the top level as well as at the underlying fund below. Because private fund investors generally consist of sophisticated individuals and/or institutional entities that more likely have the ability to understand disclosures related to performance, the Commission could alternatively require that clear and prominent disclosure accompany fund performance information that includes the impact of fund-level subscription facilities, which would state that such performance includes the impact of the fund's subscription facility and that this may cause the reported performance to be higher than if the impact of the facility were not included. This disclosure-based alternative would address the Commission's concerns that the inclusion of a subscription facility in a fund's performance calculation would potentially be misleading while at the same time reducing the compliance burden associated with producing net performance figures.

4. Written Documentation of Annual Review of Compliance Programs

While we generally support the Commission's policy goal in renewing attention on the importance of RIA annual compliance review processes, certain of our members have expressed concern as to the imposition of a prescriptive written documentation requirement for purposes of Rule 206(4)-7. When initially implemented, Rule 206(4)-7 did not include an express written documentation requirement with respect to the annual compliance review.[144] Preserving Rule 206(4)-7 in its current form does not diminish the importance of the annual compliance review process. We believe the rule's current principles-based approach fulfills this overall goal while at the same time permitting flexibility by not imposing specific prescriptive requirements with respect to such reviews (thus permitting RIAs to more effectively design and tailor their annual compliance review process to the risk profile associated with its business model and operations).

Furthermore, a written documentation requirement can be unnecessarily burdensome and duplicative for asset managers that have multiple registered investment advisers operating under a common compliance program, particularly where those registered investment advisers are advisers to RICs. For example, the Commission analogizes its proposed amendments to Rule 206(4)-7 to Rule 38a-1's requirement for a written report to the registered fund's board of directors. Notably, Rule 38a-1 does not require, and it is not the practice to, produce a written report for each and every RIC. Rather, a single report is produced at the board level for all RICs overseen by the board. As a result, one written compliance report may efficiently cover tens of RICs; indeed, anything more would be unnecessarily burdensome, duplicative, and cumbersome for boards to review and digest. With the proposed written compliance program requirement for registered investment advisers, registered investment advisers in an advisory complex would be producing

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[144] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2107 (Feb. 5, 2003).

multiple duplicative reports with little variation, and where one or more of those advisers are advisers to RICs, the report would largely be overlapping with and duplicative of the 38a-1 compliance program written report. We believe, therefore, that the 206(4)-7 written requirement is unnecessary, and at the very least should it be retained, that it be modified to not impose unnecessary duplication with other advisers under the same compliance program and/or with advisers to RICs.

Separately and with respect to records that RIAs currently maintain (including those in connection with compliance reviews), we also request that the Commission provide clarification in any subsequent adoption that an RIA may continue to make *bona fide* assertions with respect to any books and records which contain or reflect privileged information (*i.e.*, confidential communication between client and counsel seeking or providing legal advice) and that the Commission is not seeking (as part of the rule amendment process) to modify or change this well-settled law protecting privileged information contained in written materials from disclosure.[145] We do not believe that such an acknowledgment of the legitimate assertion of attorney-client privilege by an RIA is inconsistent with its existing obligation to produce required books and records to the Commission and its staff upon examination or request, and we believe that in practice, RIAs generally take care to ensure that annual compliance reviews do not in fact contain privileged information.

* * *

[145] *See* Release at 181-182 in which the Commission noted that its staff has observed claims of the attorney-client privilege, the work-product doctrine, or other similar protections over required records and that "attempts to shield from, or unnecessarily delay production of any non-privileged record is inconsistent with prompt production obligations and undermines Commission staff's ability to conduct examinations."

SIFMA AMG appreciates the opportunity to provide these comments, and sincerely appreciates your consideration of our feedback. We would be pleased to further engage on the comments contained in this letter, or on the Proposed Rule generally. If you have any questions or require additional information, please do not hesitate to contact Lindsey Keljo at 202-962-7312 (lkeljo@sifma.org), or our outside counsel, Mayer Brown LLP, attention Tram N. Nguyen at 202-263-3060 (tnguyen@mayebrown.com), Andrew J. Olmem at 202-263-3006 (aolmem@mayerbrown.com) or Adam D. Kanter at 202-263-3164 (akanter@mayerbrown.com).

Sincerely,

Lindsey Weber Keljo, Esq.
Head – Asset Management Group
Securities Industry and Financial Markets Association

cc: Honorable Gary Gensler, Chair, U.S. Securities and Exchange Commission
Honorable Caroline A. Crenshaw, Commissioner, U.S. Securities and Exchange Commission
Honorable Allison Herren Lee, Commissioner, U.S. Securities and Exchange Commission
Honorable Hester M. Peirce, Commissioner, U.S. Securities and Exchange Commission
Mr. William Birdthistle, Director, Division of Investment Management, U.S. Securities and Exchange Commission

Appendix A
Comparison of Income Allocation for European-style and American-style Waterfalls

<u>Assumptions</u>:

<u>Fund Terms</u>

- Fund A has adopted a European-style (i.e., whole fund) waterfall
- Fund B has adopted a American-style (i.e., deal-by-deal) waterfall
- Each of Fund A and Fund B has only one limited partner
- Each of Fund A and Fund B has (i) 8% preferred return hurdle, (ii) 100% general partner catch-up, and (iii) 20% carried interest

<u>Investments</u>

- The limited partner of each fund contributed $2 million
- Each of Fund A and Fund B made two investments, Investment X and Investment Y, each worth $1 million
- Investment X was sold for $2 million at the end of year 1, realizing a $1 million gain
- Investment Y was sold for $1.5 million at the end of year 2, realizing a $500,000 gain

Capital Account Table

		Fund A ("European")				Fund B ("American")			
		GP		LP		GP		LP	
Year 1	Beginning Capital Account	-		2,000,000		-		2,000,000	
	Income/Loss Allocations	200,000	*1	800,000		200,000	*3	800,000	
	Cash Distributions	-		(2,000,000)	*2	(200,000)	*4	(1,800,000)	
	Ending Capital Account	200,000		800,000		-		1,000,000	
Year 2	Beginning Capital Account	200,000		800,000		-		1,000,000	
	Income/Loss Allocations	100,000	*5	400,000		100,000	*6	400,000	
	Cash Distributions	(300,000)	*7	(1,200,000)		(100,000)	*8	(1,400,000)	
	Ending Capital Account	-		-		-		-	

*1 20% of $1 million gain to be allocated to the GP based on the hypothetical liquidation method, because the GP would be entitled to receive $200,000, if Fund A liquidates all of its assets and distribute the proceeds thereof (i.e., $3 million).

*2 Under the European-style waterfall, the entire $2 million proceeds will be distributed to the limited partner in order to fully return the limited partner's capital contribution (i.e., $2 million).

*3 20% of $1 million gain to be allocated to the GP based on the hypothetical liquidation method, because the GP would be entitled to receive $200,000, if Fund A liquidates all of its assets and distribute the proceeds (i.e., $3 million).

*4 Under the American-style waterfall, because the limited partner received its capital contribution back with respect to Investment X, any excess proceeds (i.e., $1 million) will be subject to 20% carry.

*5 Additional $100,000 gain to be allocated to the GP out of the total $500,000 gain based on the hypothetical liquidation method, because the GP would be entitled to receive $300,000 carry (i.e., 20% of $1.5 million) and the GP already has $200,000 in its capital account.

*6 $100,000 income to be allocated to the GP based on the hypothetical liquidation method, because the GP would be entitled to receive $100,000, if Fund A liquidates all of its assets and distribute the proceeds (i.e., $1.5 million) and the GP currently has a zero capital account balance.

*7 The entire sales proceeds for Investment Y (i.e., $1.5 million) to be subject to 20% carry because the GP already returned all the capital contributions from the limited partner.

*8 The realized gain from Investment Y (i.e., $500,000) to be subject to 20% carry because the GP would first need to return the $1 million capital contribution to the limited partner with respect to Investment Y.

Appendix B
Comparison of Tax Consequences to Investors of Carried Interest vs. Performance Fee

Assumptions:

- Investor A and Investor B are (i) passive U.S. individual investors and (ii) have no other source of income.
- GP/manager is entitled to 20% of current gains/income
- Effective ordinary income tax rate is 37% and effective capital gains tax rate is 20%
- Pursuant to Section 67 of the Code, investment expenses, including performance fees payable to the manager, are not currently deductible

Examples of Tax Impact of Applying Carried Interest vs Performance Fee:

Carried Interest Example

	Investor A		
Realized Capital Gains	$	7,000,000	
Realized Ordinary Income	$	3,000,000	
Carry Percentage		20%	
Carry Allocation	$	2,000,000	
Net Distribution to Investor A	$	8,000,000	
Tax Paid	$	2,008,000	*1
After-tax amount	$	5,992,000	

*1 Capital gains allocated to the investor ($5.6M = $7M – ($7M x 20%)) multiplied by capital gains tax rate of 20%, plus ordinary income ($2.4M = $3M – ($3M x 20%)) multiplied by ordinary income tax rate of 37%

Performance Fee Example

	Investor B		
Realized Capital Gains	$	7,000,000	
Realized Ordinary Income	$	3,000,000	
Performance Fees Percentage		20%	
Performance Fees	$	2,000,000	
Net Distribution to Investor B	$	8,000,000	
Tax Paid	$	2,510,000	*2
After-tax amount	$	5,490,000	

*2 Capital gains to the investor ($7M) multiplied by capital gains tax rate of 20% and ordinary income ($3M) multiplied by ordinary income tax rate of 37%.

Difference in After-Tax Amount **$** **502,000**

Investor A receives 9.14% (*i.e.*, $502,000/$5,490,000) more after-tax distributions as compared to Investor B.

Appendix C
Illustration of the Limitations on the Ability of a Carry Recipient to Claim a Loss Deduction for a Clawback Payment

Assumptions:

- Carry Recipient A is an individual and Carry Recipient B is a corporation
- Ordinary income tax rate for individuals is 37% and capital gains tax rate for individuals is 20%
- Ordinary income and capital gains tax rates are 21% for corporations
- Each carry recipient was allocated $2,000,000 income with respect to its carried interests, 70% of which is capital gain and 30% ordinary income
- Each carry recipient received $1,500,000 carried interest distributions out of $2M carry income allocations (e.g., $500,000 was reported as phantom income)
- Each carry recipient was subject to the GP clawback in the amount of $1,200,000
- The fund was liquidated immediately after the GP clawback and the remaining capital account balance was claimed as a capital loss

Capital loss was not deductible in the year of payment as there were no other tax items in that year		Carry Recipient A			Carry Recipient B	
Capital Gains Allocations in Prior Years	$	1,400,000		$	1,400,000	
Ordinary Income Allocation in Prior Years	$	600,000		$	600,000	
Carried Interest Distributions	$	1,500,000		$	1,500,000	
Amount subject to clawback	$	1,200,000		$	1,200,000	
Cash received	$	1,500,000		$	1,500,000	
Tax Paid	$	(502,000)		$	(420,000)	
Clawback Payment	$	(1,200,000)		$	(1,200,000)	
Net Cash	$	(202,000)	*1	$	(120,000)	*1

*1 In both cases, the carry recipient will be in a negative after-tax cash position even though it was entitled to receive a $300,000 net carried interest on a before tax basis.

Capital Account/Amount of Loss

	Carry Recipient A			Carry Recipient B		
Income Allocations	$	2,000,000		$	2,000,000	
Distributions	$	(1,500,000)		$	(1,500,000)	
Clawback Payment	$	1,200,000		$	1,200,000	
Ending Balance	$	1,700,000		$	1,700,000	
Capital Loss	$	(1,700,000)	*2	$	(1,700,000)	*3

*2 For individual taxpayers, capital loss can be deducted only against capital gains, and only up to $3K against ordinary income. This capital loss will not deliver any meaningful tax benefits to the carry recipient unless the carry recipient recognizes sizable capital gains.

*3 For corporate taxpayers, capital loss can be deducted only against capital gains, and can only be carried forward for five years. After five years, any remaining capital loss carryover will be purged and provide no actual or potential tax benefits to the carry recipient.

Appendix D
Comparison of Certain Aspects of the Proposed Rule's Quarterly Statements Requirement vs. Mutual Fund Disclosure Requirements under the Investment Company Act

Category	Proposed Rule – Quarterly Statements	Mutual Funds
Reporting Deadlines	**45 days** following reporting period	*Time Periods generally are longer for mutual funds:* • **60 days** following reporting period for annual and semi-annual shareholder reports (Rule 30e-1(c) under the Investment Company Act) • **120 days** after fiscal year end for mutual fund prospectuses (Rule 8b-16 under the Investment Company Act, Form N-1/A)
Frequency	**Quarterly**	*Most key information provided annually (or semi-annually) to mutual fund shareholders:* • **Annually** for mutual fund summary prospectuses (Rule 498 under the Securities Act of 1933) • **Semi-annually** for annual and semi-annual shareholder reports (annual reports contain audited information) (Form N-1A, Item 27(b) and (c), Section 30(e) of the Investment Company Act)
Fees and Expenses Table	The quarterly statement's Fund Table must include a *detailed* accounting of **all** adviser compensation as well as private fund fees and expenses paid during the reporting period, with **separate line items** for each category of allocation or payment and fee or expense reflecting the total dollar amount.	*Comparable Mutual Fund Prospectus Fee Table Requires Less Granular, Aggregated Detail:* • For a mutual fund summary prospectuses' Fee Table, fund expenses generally are grouped into three broad categories (advisory fees, distribution fees and other expenses) followed by a total annual fund operating expenses figure. Funds of funds can include a separate Acquired Fund Fees and Expense sub-caption. An aggregated figure is disclosed for each category. Funds have the *option* but are not required to break the "other expenses" into a maximum of three sub-caption categories and have the option to display fee waivers and expense reimbursement arrangements that last at least one year in separate before/after line items. (Form N-1A) No standard fee and expenses table is required in annual and semi-annual shareholder reports. However, aggregate information about advisory compensation as well as fund fees and expenses generally is disclosed in the financial statements and elsewhere in the shareholder reports. (Form N-1A, Item 27(b) and (c), Section 30(e) of the Investment Company Act)

Category	Proposed Rule – Quarterly Statements	Mutual Funds
Electronic Delivery for Shareholder Reports	RIAs must comply with SEC staff's electronic delivery guidance, which generally requires advisers to consider three key issues (notice, access and evidence to show delivery) to establish that such electronic distribution results in the delivery of substantially equivalent information as the client would have received if the information were sent in paper form. This could be established by ensuring that the client has appropriate notice of the delivery of such materials (and a consideration as to whether a supplemental notice of such electronic dissemination is necessary); that such client has appropriate access to such materials (*e.g.,* an ability to print, retain and download information); and that the adviser has a reasonable belief that sending information electronically satisfies applicable delivery requirements. With respect to the latter, RIAs could obtain the client's informed consent with respect to electronic delivery, obtain evidence that the intended recipient actually received the information (*e.g.,* e-mail return receipt or by confirmation that the information was accessed, downloaded or printed), or disseminate though facsimile delivery. (*See* Securities Act Release No. 7233 (October 6, 1995), Securities Act Release No. 7288 (May 9, 1996, and Securities Act Release No. 7856 (April 28, 2000)). As a practical matter, many RIAs pursue the client consent route given the administrative complexity associated with the other alternatives.	*Mutual funds are able to rely on a more flexible "notice and access" electronic delivery method conditionally permitting them to post shareholder reports on their websites.* Rule 30e-3 under the Investment Company Act provides an optional "notice and access" method to allow mutual funds to transmit shareholder reports electronically. Subject to certain conditions in the rule, a mutual fund may satisfy its delivery requirements by making its shareholder reports and other required materials publicly accessible electronically at a specified website address, free of charge, and sending investors a paper notice of each report's availability by mail. Investors that prefer paper copies could elect to have existing or future reports sent for free in hard copy.