February 26, 2022

Via e-mail: rule-comments@sec.gov

Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: File Number S7-03-22, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*

Dear Ms. Countryman:

We appreciate the opportunity to comment on the new rules proposed for private fund advisers under the Investment Advisers Act of 1940. Our comments pertain only to the proposed "Mandatory Private Fund Adviser Audits" (Section II.B. of Release No. IA-5955). In summary, empirical evidence suggests that mandatory audit and GAAP usage requirements are neither necessary nor beneficial for private equity and venture capital funds. As such, we suggest that the SEC revise or eliminate the proposed audit and GAAP usage requirements for private equity and venture capital funds.

Please feel free to contact Steven Utke [redacted] if you have questions about this letter.

Sincerely,

/s/ Steven Utke

Steven Utke
Associate Professor
University of Connecticut

/s/ Paul Mason

Paul Mason
Assistant Professor
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I. Background

Release IA-3221 (Federal Register, Vol. 76, No. 138, July 19, 2011) implements rules ("Rules") to give effect to the provisions of Title IV of the Dodd-Frank Act regarding the SEC's registration and reporting requirements for advisers to private equity, venture capital, and hedge funds (collectively, "private funds"). The Rules require certain private fund advisers that were previously exempt under the Investment Advisers Act of 1940 to register with the SEC. Further, the Rules amend the SEC's Form ADV to facilitate the new registration and reporting requirements. For example, the revised Form ADV provides *private fund-level*, rather than only adviser-level, information.

The Rules also require certain registered private funds to obtain audits ("non-exempt") while exempting other registered private funds ("exempt") from the audit requirements. No private funds are currently required to use U.S. Generally Accepted Accounting Principles ("GAAP") under the Rules. In our comments, we discuss the results of empirical studies of the determinants and consequences of audit and GAAP usage in certain registered private funds.

II. Empirical Evidence Regarding "Mandatory Private Funds Audits"

While public markets require disclosure of audited financial statements prepared under U.S. GAAP, private markets differ substantially from public markets on a number of dimensions[1] (note: we do not comment on the value of audits or GAAP in public markets). First, private markets are generally open only to sophisticated accredited investors, in contrast to public markets that are open to all investors.[2] Second, Regulation Fair Disclosure ("Reg FD") does not apply to private funds.[3] As a result, sophisticated investors in private markets obtain information directly from private funds without publicly disclosed or audited financial statements.

Given that information can pass directly from private funds to investors, it is important to understand if audited financial statements are relevant to these private market investors. Recent studies empirically evaluate the value of audits in private markets, specifically related to private equity (PE) and venture capital (VC) funds ("funds"). Most importantly, Gaver et al. (2022)[4] evaluate the determinants and consequences of funds' audit and accounting method choices. Also of importance, Easton et al. (2021)[5] evaluate auditors' ability to improve net asset value (NAV) estimation for funds.

First, Gaver et al. (2022) find that most funds exempt from the audit requirement under the Rules – about 60% to 80% of exempt funds (depending on whether the sample is equal- or value-weighted) – voluntarily obtain audits. The authors find that the decision to obtain an audit is driven by fund and investor attributes, suggesting that investors demand, and funds provide,

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[1] For details on notable differences between public and private markets, see Borysoff, M. N, P. Mason, and S. Utke. 2022. Understanding private equity funds: A guide to private equity research in accounting. Working paper.
[2] Release Nos. 33-10824; 34-89669; File No. S7-25-19.
[3] Release Nos. 33-7881, 34-43154, IC-24599, File No. S7-31-99.
[4] Gaver, J. J., P. Mason, and S. Utke. 2022. Does accounting matter for capital formation? Determinants and consequences of private equity fund financial reporting choices. Working paper.
[5] Easton, P., S. Larocque, P. Mason, and S. Utke. 2021. Accuracy and bias in private equity fund net asset values. Working paper.

audited financial statements while considering the individual attributes of each specific fund. For example, audits may be particularly costly for smaller funds, who may not view the cost of an audit as worthwhile. Imposing mandatory audits may discourage such funds from forming. About 65% of audited exempt funds (both equal- and value-weighted) use GAAP. This use of GAAP is notable given concerns over fair value accounting under GAAP; many funds may prefer industry-specific accounting practices and standards. As with audits, GAAP usage is driven by fund and investor attributes, suggesting that investors demand, and funds provide, GAAP or non-GAAP financial statements considering the individual attributes of each specific fund.

Second, Gaver et al. (2022) find only limited evidence that audited GAAP financial statements provide capital market benefits to funds; whether or not an adviser obtains audits or uses GAAP for its funds has a mixed effect, at best, on the adviser's ability to raise new funds. That is, only in a few cases does the presence of audited GAAP financial statements appear to increase investors' willingness to invest in new funds. Consistent with this, the rate of voluntary audits and GAAP usage among exempt funds appears to be declining over time (though still high). This suggests that imposing mandatory audits and GAAP usage on funds is unlikely to provide the benefits that the SEC envisions, while certainly imposing high compliance costs.

Third, Easton et al. (2021) evaluate factors that affect the bias (i.e., optimism) and accuracy (the closeness of the fund's NAV estimate to the actual *ex post* value) of PE and VC funds' reported NAVs. Consistent with Gaver et al.'s (2022) finding of limited benefits to audits, Easton et al. (2021) find that audits appear to improve accuracy and reduce bias in NAVs, but the effect is only detectable in limited circumstances. As such, it is not clear that a general audit mandate will address the SEC's concerns, expressed in the proposed rule, about bias in NAVs.

III. Conclusion

In summary, while this research area is still developing, preliminary studies provide limited evidence that audits and GAAP usage in funds generate benefits. Further, the majority of exempt funds obtain audits voluntarily. These findings suggest that funds likely weigh fund-specific costs and benefits when making audit, GAAP, and other financial reporting choices.[6] Importantly, audits and GAAP usage appear to facilitate advisers' ability to raise new funds only in limited circumstances, suggesting that they may have limited value, and audits only improve reported NAVs in limited circumstances. Thus, imposition of mandatory audits and GAAP usage are unlikely to provide the desired benefits while imposing costs on all funds. Some funds may be unable to bear these costs, potentially discouraging capital formation and, ultimately, economic activity and innovation.

[6] Numerous important papers providing additional insights are in progress. We encourage the SEC to visit our research websites (https://ssrn.com/author=1688312 or https://ssrn.com/author=2439002) where our work on these topics will be posted when available.