



National Association of
Investment Companies

The Largest Network of Diverse-Owned
Private Equity Firms and Hedge Funds

1300 Pennsylvania Avenue, NW, Suite 700
Washington, DC 20004

April 22, 2022

VIA ELECTRONIC SUBMISSION

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

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

Dear Ms. Countryman:

On behalf of the National Association of Investment Companies (“NAIC”), we appreciate the opportunity to submit this letter to the Securities and Exchange Commission (“SEC”) on the proposed rules in SEC Release No. IA-5955; File No. S7-03-22 (the “Proposal” or “Proposed Rules”) regarding investment advisers to private funds. The National Association of Investment Companies (NAIC), a 501(c)(6) founded in 1971, is the largest network of diverse-owned private equity firms and hedge funds. NAIC member firms are owned by ethnic minorities (African American, Hispanic, Asian-Indian, Asian-Pacific, and Native American) or owned by women. Comprised of 155 member firms representing over \$260 billion in assets under management and thousands of portfolio companies, in the aggregate, NAIC member firms generate superior returns that help drive the growth in pensions, endowments, and other investment assets under management in the U.S. and abroad.

The U.S. Government Accountability Office (GAO) reported in 2017 that asset management firms registered in the U.S. managed over \$70 trillion and that minority- and women-owned firms managed less than 1 percent of those assets.¹ The GAO study highlighted diverse- and women-owned asset managers face challenges when competing for investment management opportunities with institutional investors and raised questions about how often federal entities use diverse asset managers and the transparency of their selection processes. Two of the main challenges referenced include: (1) institutional investors and their consultants often

¹ *Investment Management: Key Practices Could Provide More Options for Federal Entities and Opportunities for Minority- and Women-Owned Asset Managers*, U.S. Government Accountability Office, September 2017.

prefer to contract with large, majority-owned asset managers with brand recognition and with whom they are familiar, and (2) small firms, including many diverse and women-owned firms, are often unable to meet minimum requirements set by institutional investors such as size, measured by assets under management, and past experience or the length of a manager's track record.

The U.S. asset management industry increased to \$103 trillion at the end of 2020;² however, the proportion of assets under management by diverse and women-owned firms has not grown at a pace which is consistent with the overall industry. This is not attributable to lack of performance. Several studies have documented the outperformance of diverse and women-owned funds. KPMG has collected, aggregated, and analyzed the returns of the NAIC's General Partner member firms, all diverse-owned funds, from 1998 through 2020 to provide investors with more data points as they consider whether diverse asset management firms can make a positive contribution to an investment portfolio. Over the 22-year period, Diverse Private Equity funds, represented by NAIC member funds in the NAIC Private Equity Index, recorded higher net internal rates of return (IRRs) than the Burgiss Median Quartile in 76.5% of the vintage years studied. Moreover, Diverse Private Equity funds outperformed the Burgiss median in 83.3% of the periods measured on a net multiple on invested capital (MOIC) basis.³

As many U.S. institutional investors have taken deliberate steps to ensure the allocation of assets to diverse and emerging managers, the disproportionately lower level of commitments to diverse and emerging managers versus their peers persists despite the documented outperformance of these managers. The SEC's Proposal would impose additional requirements and barriers of entry for diverse managers and exacerbate the disparity. If adopted, the Proposed Rules would significantly increase the expenses to perform the administrative tasks required to comply with many aspects of the Proposal. By imposing cost-prohibitive requirements for funds led by emerging and diverse managers, the substantive prohibitions would continue to promote racial bias within the industry and make it more difficult than it has been historically for diverse and emerging managers to compete with incumbent managers with significantly more resources.

We request the SEC reconsider its position, as the Proposal would unnecessarily negatively impact and impede the growth of small and diverse managers versus their majority-owned, and generally larger, manager peers. Over the last two years, NAIC has experienced the fastest growth in membership in the venture capital and growth and expansion categories of private equity as NAIC and its member firms have focused on the wealth gap in America, particularly for African-Americans and Hispanics, by increasing venture capital and growth and expansion investments, which are uniquely positioned to help reduce the Black and Brown-White wealth gap. By their nature, venture capital and growth and expansion transactions can create significant wealth for diverse founders, their ecosystem of friends, family members, and other investors in the deals, and the company's employees. The Proposed Rules would undermine the recent progress that has been achieved and limit the potential of private equity managers to create jobs, generate wealth, and improve communities across this country.

² "The Asset Management Industry Has Surpassed \$100 Trillion - And There's Still Room to Grow," Chung, Grace, *Institutional Investor*, July 08, 2021.

³ Examining The Returns –The Financial Returns of Diverse Private Equity Firms," Aon Investments USA, 2021.

In addition, the Proposal's reporting requirements will add significant costs and expenses that will be difficult for emerging and smaller diverse and women-owned investment firms to bear. Firms with the back-office infrastructure able to comply with the requirements will need to pass the additional costs and expenses to investors, making them and their investment offerings less competitive. Worse still, the additional reporting requirements and expenses will reduce the number of experienced diverse and women investors capable of launching their own firms and put firms unable to afford the burden of the additional expenses out of business. The proposed prohibited-activities rules will also increase management fees paid by limited partners in the funds and make smaller fund offerings less attractive.

Another critical drawback of the Proposed Rules is the plan to effectively eliminate the standard of care typically relevant for investment advisers. The gross negligence standard is vital in private equity, as it is designed to encourage managers to take risks to generate returns that are generally higher than other asset classes. If the Proposal is adopted, private equity fund managers will need to amend existing management agreements and governing documents, which typically limit private equity managers' liability except to the extent the private fund adviser has acted with gross negligence. Additionally, the proposed prohibition is not limited to prohibiting indemnification upon an independent determination that the conduct constitutes negligence, potentially allowing for wide-ranging disputes as to whether the manager's conduct constituted negligence. The increased liability could be unlimited and will increase fees for diverse and women-owned managers, while deterring the creation of diverse and women-owned firms.

Furthermore, other elements of the Proposal Rules increase the cost of doing business for fund managers and will have the most negative impact on diverse and women-owned firms that are less established. The prohibition of after-tax clawbacks is problematic and will require fund managers to revisit all clawback calculations for existing funds to adjust any clawback amounts due to investors. The prohibition of certain fees and expenses and the requirement to obtain fund audits also make it more difficult for smaller and diverse and women-owned managers to comply.

Finally, it is highly concerning the Proposal lacks economic analysis on the impact on diverse and women-owned funds and the overall economy. The economic impact of the Proposed Rules has not been quantified and should be evaluated on a comprehensive basis. It is our belief that the impact on emerging, diverse, and women-owned funds will be significant. The Proposal will make it more difficult for the creation of diverse and women-owned firms and will cause existing firms to be less competitive with well-established players in the industry.

On behalf of the NAIC, we would like the SEC to truly consider the negative economic impact the Proposal will have on diverse and women-owned investment managers and the additional barriers to entry the Proposed Rules will impose on experienced diverse and women investment professionals seeking to establish their own firms. Over the last several years, there has been significant growth in the number and diversity of investment firms. The Proposal, if adopted, will diminish this growth. We do not believe the policy rationale provided for many of the additional requirements justifies the burdens, costs, and expenses that will be placed on smaller, emerging firms and those that are diverse and women-owned. The Proposal will have a detrimental and disproportionate negative impact on diverse and women-owned asset managers. We will remain available to the SEC to further advocate on behalf of our members and other

diverse and women-owned investment managers. We thank the Commission for considering NAIC's comment on the Proposal.

Sincerely,

A handwritten signature in blue ink, appearing to read "Robert L. Greene", enclosed in a thin black rectangular border.

Robert L. Greene
President & CEO