THE VOICE OF PRIVATE CAPITAL
VENTURE CAPITAL
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INFRASTRUCTURE
LONG TERM INVESTORS

April 25, 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:

We are writing on behalf of Invest Europe, the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors. Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

We therefore welcome the opportunity to provide feedback on the U.S. Securities and Exchange Commission (the "SEC") proposals relating to private fund advisers (Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955 (Feb. 9, 2022) ("Private Funds Rules Proposing Release")) under Investment Advisers Act of 1940 (the "Advisers Act") and in particular Rule 206(4)-10 (the "Private Fund Audit Rule"); Rule 211(h)(2)-1 (the "Prohibited Activities Rule"), Rule 211(h)(1)-2 (the "Private Fund Quarterly Statements Rule"), Rule 211(h)(2)-2 (the "Adviser-Led Secondaries Rule"), and Rule 211(h)(2)-3 (the "Preferential Treatment Rule"; together the "Private Fund Rules").

We would like to note that we prepared this response in coordination with national European trade associations. As most European jurisdictions are subject to a similar financial services regulatory framework, either because they are subject to European Union (EU) law or because their legislative corpus is largely derived from EU law (this is for example the case of the UK), our responses were prepared jointly and are therefore very similar.

1. How The Proposed Private Fund Rules Affect Our Members

Our members will become subject to the Private Fund Rules in a variety of manners. Although certain firms amongst our membership will be subject to the Private Fund Rules simply by virtue of having a principal place of business within the U.S., we defer largely to our colleagues at the American Investment Council (the "AIC") to provide the perspective of such firms on the SEC's proposals (although we make a number of representations that overlap with the those of the AIC).

Most of our members are investment advisers with a principal place of business outside of the United States ("non-U.S. advisers"), who principally provide advice with respect to private funds organized outside of the United States ("non-U.S. private funds"). Certain of our members may be subject to the jurisdiction of the Advisers Act due to one or more of the following: (i) soliciting U.S. persons to invest in their private fund, (ii) maintaining a place of business, subsidiary or affiliate in the United States, or (iii) providing advice with respect to U.S. private funds or other types of U.S. clients. The perspective and feedback set out in this letter is therefore principally that of non-US advisers advising non-US funds.

Most of our members who are subject to the Advisers Act rely on the following exceptions from registration under the Adviser Act: (i) the foreign private fund adviser exemption in Section 203(b)(3) ("foreign private advisers") or (ii) either of (a) the venture capital fund adviser exemption in Section 203(l) or (b) the private fund adviser exemption in Section 203(m) (together "exempt reporting advisers"). However, certain of our members are non-U.S. advisers who have registered with the SEC.

2. General Comments

First of all, we would like to clarify that, as we are an association based outside the US, our feedback does not comment on the lawfulness of the Private Fund Rules (in relation to which we refer the SEC to the feedback provided by the AIC). Instead, we focus strictly on and make recommendations relating to the proposals' policy, practical and commercial implications.

That said, we would like to share with the SEC a general concern with the appropriateness of any proposals, as they create regulatory interference in commercial agreements will hamper investors' freedom and ability to negotiate terms that work for them.

We argue that market practice, investor pressure and a combination of voluntary reporting frameworks and mandatory rules already achieve the necessary level of transparency.

Most importantly, we fundamentally disagree with the prescriptive approach that has been taken by the SEC and by the extent of its territorial scope. Should the SEC seek to impose new rules – preconditioned on such actions being legal in the first place – these should remain principles-based and should never seek to impose strict conditions on a private relationship between two experienced and professional negotiating parties.

We invite the SEC to examine how these principles are followed in existing European law and regulation which, although often too prescriptive in its reporting requirements, does tend to acknowledge the basic principle of contractual freedom between sophisticated parties and clearly makes a distinction between professional and retail-aimed rules. To that extent, we note that the Private Fund Rules clearly have the potential to render the U.S. less competitive compared to other jurisdictions, whilst reducing the range of investment choices available to U.S. investors.

Most problematically from a European perspective, elements of the Private Fund Rules that will apply to non-U.S. advisers will create serious conflicts of laws issues – as these firms are already subject to existing regulation in their home jurisdictions, often designed to achieve similar policy objectives and provide similar protections to investors. We detail further in Section 3 and

elsewhere how some of the Private Fund Rules are likely to conflict with non-US law. The SEC should recognise that the Private Fund Rules should not apply to non-U.S advisers advising on non-US funds.

Finally, we note that the proposal lacks a grandfathering clause and suggest inserting such a clause into the framework, which would cause wide-ranging and difficult-to-predict effects on thousands of private fund advisers and private funds. In proposing the Private Fund Rules, the SEC acknowledges that the Rules are intended to affect the balance of negotiations between private fund advisers and investors[1] and are likely to affect future agreements.[2] Therefore, without a grandfathering clause for existing agreements, the proposed Rules would have sweeping effects on virtually all private fund agreements, increasing costs on both private fund advisers and private fund investors. The SEC, however, does not address the inequity of retroactively changing the private bargain between private fund advisers and investors. Furthermore, the potential of adjusting these private fund agreements, whether unilaterally or through re-negotiation and consent, varies dramatically based on a range of factors, including the jurisdiction of the private fund and the private fund adviser. We strongly urge the SEC to provide a grandfathering clause with respect to all existing contractual agreements.

3. **Extraterritorial Application to Non-U.S. Investment Advisers**

The Prohibited Activities Rules Should Not Apply to Relationships Between Non-U.S. Advisers and Non-U.S. Funds Based on Long-Standing SEC Interpretation of Extraterritorial Limitations. The SEC has proposed that the Prohibited Activities Rule would not apply to a registered non-U.S. adviser with respect to non-U.S. private funds.[3] We support this position as it is consistent with the long-standing view of the SEC and the SEC staff that most of the substantive

1 See, e.g., Private Funds Proposing Release at 19 (expressing a hope that "the investor may be in a better position to negotiate lower fee rates for future investments because the investor would be aware of the rates charged by certain advisers in that segment of the market"); 132 (expressing concern for "smaller investors that are not able to negotiate preferential deals with the adviser and its related persons"); 151 & fn. 173 (expressing concern "where investors with less bargaining power are forced to bear the brunt of such arrangements"); 194 (expressing concern for investors "are not able to negotiate or directly discuss the terms of the borrowing with the adviser"); 195 (expressing concern that "some investors may find it relatively difficult to negotiate agreements that would fully protect them from bearing unexpected portions of fees and expenses or from other decreases in the value of investments associated with the above-described practices"); 196 (expressing concern that due to a "lack of transparency" on preferential treatment "investors may simply be unaware of the types of contractual terms that could be negotiated"); 217 (stating that disclosure may not be sufficient because "many of these conflicts of interest and sources of harm may be difficult for investors to detect or negotiate terms over"); 221 (noting one of the goals of the rules is to "improve the ability of investors to negotiate terms related to the governance of the fund"); 222 (stating that "[i]nvestors may also have an improved ability to negotiate expenses and other arrangements in any subsequent private funds raised by the same adviser").

2 See, e.g., Private Funds Proposing Release at 236 (noting that adviser may negotiate a "a new fixed management fee to compensate for the new costs"); 238 – 239 (noting that advisers may "re-negotiate, re-structure and/or revise certain existing deals or existing economic arrangements in response to" the Private Fund Rules); 241 (same); 243 (same); 247 (same); 248 (same).

3 Private Funds Rules Proposing Release at p. 134 – 135 ("Similarly, the proposed prohibited activities rule would not apply to a registered offshore adviser's private funds organized outside of the United States, regardless of whether the private funds have U.S. investors.")

provisions of the Advisers Act should not apply with respect to a non-U.S. adviser's relationship with its non-U.S. clients and non-U.S. funds (including funds with U.S. investors). [4]

This SEC position has been based on the following main principles:

- *Investor Expectations*: Both U.S. and non-U.S. investors in non-U.S. funds "do not expect, and may not desire, a foreign adviser to be subject to the Advisers Act."[5]

- *International Comity/Conflicts of Laws*: Applying all of the substantive provisions of the Advisers Act to a non-U.S. adviser's non-U.S. advisory business "could result in inconsistent regulatory requirements or practices imposed by the regulations of their local jurisdiction and the U.S. securities laws."[6]

- *Detrimental U.S. Market Impacts*: Applying all of the substantive provisions of the Advisers Act to a non-U.S. adviser's non-U.S. advisory business would deter non-U.S. advisers from engaging in activities that would subject themselves to the Advisers Act, which would result in U.S. investors being deprived of the expertise of non-U.S. advisers.[7]

We request the following clarifications on the guidance with respect to the extraterritorial application of the Private Fund Rules.

Confirm That Same Extraterritorial Interpretation Applies to Exempt Reporting Advisers and Foreign Private Advisers. The release language with respect to the Prohibited Activities Rule was

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[4] SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (May 1992), available at https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf ("Protecting Investors Study") at 229 ("[c]omity suggests that the Advisers Act should not apply to a foreign registered adviser's relationship with its non-United States clients outside the United States, just as the Commission would not expect the laws and regulations of a foreign country to apply to a United States adviser's relationship with its United States clients"); Uniao de Banco de Brasileiros S.A., SEC Staff No-Action Letter (July 28, 1992) ("Unibanco")("Under the Division's approach, the substantive provisions of the Advisers Act generally would not apply with respect to a foreign registered adviser's non-United states clients"); Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333 (Dec. 2, 2004) ("Hedge Fund Adviser Registration Adopting Release") at fns. 211 – 213 and the accompanying paragraph (stating that that "the substantive provisions of the [Advisers Act] generally would not apply to the offshore adviser's dealings with the offshore fund."); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3222 (Jun. 22, 2011)("Exemptions Adopting Release")(re-iterating "long-held view that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and that this territorial approach is in keeping with general principles of international comity").

[5] Protecting Investors Study at 229; Hedge Fund Adviser Registration Adopting Release at fn. 213 (stating that "U.S. investors in [a non-U.S. fund advised by a non-U.S. adviser] generally would not have reasons to expect the full protection of the U.S. securities laws.")

[6] Exemptions Adopting Release at fn. 393 and the accompanying text (citing the Protecting Investors Study); Unibanco (expressing concern that "the Advisers Act may prohibit them from engaging in business practices with their foreign clients that are both legal and customary in their home countries."); Hedge Fund Adviser Registration Adopting Release at fn. 213 (nothing that "[t]he laws governing such a fund would likely be those of the country in which it is organized or those of the country in which the adviser has its principal place of business.").

[7] Protecting Investors Study at 229 (discussing "the unfortunate effect of limiting United States investors' access to foreign advisory expertise"); Hedge Fund Adviser Registration Adopting Release at fn. 213 (noting that "as a practical matter, U.S. investors may be precluded from an investment opportunity in offshore funds if their participation resulted in the full application of the Advisers Act and our rules").

limited to registered non-U.S. advisers.[8] Since the Prohibited Activities Rule would apply to all investment advisers (including exempt reporting advisers and other unregistered advisers), we request that the SEC confirm that this interpretation applies to all non-U.S. advisers, regardless of their registration status. We can think of no reason why the substantive provisions of the Advisers Act would apply to non-U.S. exempt reporting advisers or foreign private advisers to a greater extent than registered non-U.S. investment advisers. The principles for limited extraterritorial effect are stronger with respect to non-U.S. exempt reporting advisers and foreign private fund advisers, as the SEC recognized when adopting the rules implementing those exemptions.[9] We believe that applying these Rules to non-U.S. exempt reporting advisers with respect to their non-U.S. funds would run counter to the SEC's goal of establishing "appropriate limits on the extraterritorial application of the Advisers Act" when adopting the implementing rules relating to the new exceptions established under the Dodd-Frank Act.[10]

Confirm That Same Extraterritorial Interpretation Applies to the Other Private Fund Rules. We request that the SEC clarify that the other Private Fund Rules, specifically (i) the Private Fund Audit Rule, (ii) the Private Fund Quarterly Statements Rule, (iii) the Adviser-Led Secondaries Rule and (iv) the Preferential Treatment Rule, also would not apply to non-U.S. investment advisers (registered and unregistered) with respect to non-U.S. private funds.

Consistent with Extraterritorial Principles. We believe that limiting the proposed Private Fund Rules in this fashion would be consistent with the general principles relating to the limits of the extraterritorial application of the Advisers Act discussed above. First, investors in non-U.S. funds of non-U.S. investment advisers generally do not expect the full protection of the Advisers Act and, therefore, we believe they would not expect the applicability of the Private Fund Rules. This would be particularly true with respect to non-U.S. exempt reporting advisers and foreign private advisers, whose investors often have little awareness of or concerns as to how the Advisers Act applies at all with respect to their investment in a non-U.S. fund.

Second, there is a significant risk of conflicts between the Private Fund Rules and the laws and regulations of non-U.S. jurisdictions.[11] This is particularly true due to the prescriptive nature of the Private Fund Rules, as opposed to the historically more principles-based approach of with respect to the anti-fraud provisions of the Advisers Act. These conflicts of laws can create confusion for investors as to what the applicable law is and also present operational challenges for a private fund adviser who has to weigh competing legal and regulatory requirements.

Finally, the difficulties of complying with Private Fund Rules would present significant deterrence to non-U.S. investment advisers soliciting U.S. investors if it substantially increased their regulatory obligations under the Advisers Act (in addition to and duplicative of the regulatory

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8 See Private Funds Rules Proposing Release at p. 135 ("Similarly, the proposed prohibited activities rule would not apply to a registered offshore adviser's private funds organized outside of the United States, regardless of whether the private funds have U.S. investors.")

9 Exemptions Adopting Release at p. 96 (that Rule 203(m)-1 was "designed to encourage the participation of non-U.S. advisers in the U.S. market by applying the U.S. securities laws in a manner that does not impose U.S. regulatory and operational requirements on a non-U.S. adviser's non-U.S. advisory business.").

10 Exemptions Adopting Release at fn. 320 and the accompanying sentence.

11 We have highlighted a few specific examples of conflicts in this comment letter; however, we are also concerned about future conflicts as a result of changes in laws and regulations applicable to non-U.S. investment advisers in non-U.S. jurisdictions.

obligations imposed on them by their home jurisdiction, often with the aim of achieving the same investor protections), which would deprive U.S. investors the ability to access the investment expertise of many non-U.S. investment advisers.

Consistent With Extraterritorial Limitations on Advisers Act Rules Covering Similar Areas. We further note that the SEC has previously taken a similar position with respect to several existing rules that cover similar areas to the other proposed Private Fund Rules. For example, the SEC has taken the position that non-U.S. registered investment advisers are not required to comply with Rule 206(4)-2 (the "Custody Rule") with respect to their non-U.S. clients (including non-U.S. private funds).[12] The Custody Rule houses the existing audit requirements for private funds and it would be inconsistent from a policy perspective to treat the Private Fund Audit Rule differently. Similarly, the SEC has stated that a non-U.S. registered investment adviser is not required to comply with Rule 206(4)-1 (the "Marketing Rule") with respect to their non-U.S. clients.[13] Therefore, we believe that the SEC should take a similar position with respect to the Private Fund Quarterly Statements Rule. The SEC has taken the position that a non-U.S. registered investment adviser is not required to comply with the contractual requirements set forth in Section 205 of the Advisers Act with respect to its non-U.S. clients.[14] This position that the Advisers Act should not impose prescriptive requirements on the contractual relationships between non-U.S. investment advisers and non-U.S. clients supports why, among others, the Preferential Treatment Rule should not apply to such contractual relationships either. Finally, the SEC also took the position that prohibitions on principal transactions in Section 206(3) would not apply with respect to non-U.S. clients of non-U.S. advisers.[15] For similar reasons, we believe that the Adviser-Led Secondaries Rule should not apply since it appears to present similar (albeit less significant) conflicts of interest from principal transactions.

Furthermore, more generally, the SEC has also taken the same position with respect to virtually all of the prescriptive substantive provisions and rules of the Advisers Act, including, in addition to those mentioned above, Rule 204-3 (with respect to the delivery of brochures),[16] Rule 204A-1 (the Code of Ethics rule),[17] the withdrawn Rule 206(4)-3 (the cash solicitation rule),[18] Rule 206(4)-6 (the proxy voting rule),[19] and Rule 206(4)-7 (the compliance policies rule).[20]

Reasons for Exceptions to Extraterritorial Application of Prescriptive Rules Do Not Apply to the Private Fund Rules. There are two limited exceptions where the SEC applies prescriptive rules to non-U.S. investment advisers. First, the recordkeeping rule (Rule 204-2) enables the SEC "to monitor and enforce the adviser's performance of its obligations to its United States clients and to ensure the integrity of United States markets."[21] Even in this case, the SEC still significantly limits which parts of the books and records a non-U.S. registered investment adviser is required to

12 Hedge Fund Adviser Registration Adopting Release at fns. 218 – 220 and the accompanying sentence.
13 Investment Adviser Marketing, SEC Release No. IA-5653 (Dec. 22, 2020) at 63 – 64.
14 Hedge Fund Adviser Registration Adopting Release at fn. 221.
15 Hedge Fund Adviser Registration Adopting Release at fn. 221.
16 Hedge Fund Adviser Registration Adopting Release at fn. 221.
17 Hedge Fund Adviser Registration Adopting Release at fn. 222 and the accompanying sentence.
18 Hedge Fund Adviser Registration Adopting Release at fn. 221.
19 Hedge Fund Adviser Registration Adopting Release at fn. 220 and the accompanying sentence.
20 Hedge Fund Adviser Registration Adopting Release at fn. 218 and the accompanying sentence.
21 Uninbanco at fn. 8 and the accompanying sentence.

follow.[22] We also note that Rule 204-2 does not apply at all to any non-U.S. exempt reporting advisers or foreign private advisers.

Second, the pay-to-play rule (Rule 206(4)-5) includes implicit extraterritorial limitations since it only applies with respect to contributions and other activities with respect to U.S. state and local government entities.

We see no reason why the SEC would take a different approach with respect to the extraterritorial application of the Private Fund Rules, since they are prescriptive rules that neither include the implicit extraterritorial limitations of the pay-to-play rule nor support the SEC's monitoring and enforcement of the adviser's relationship with its U.S. clients like the recordkeeping rule.

4. Specific Comments on the Proposed Private Fund Rules

In addition to the comments on the extraterritorial application of the Private Fund Rules set forth above, we also have several specific concerns with the proposed Private Fund Rules, both specifically with respect to non-U.S. advisers but also more generally to all private fund advisers.

(a) Rules Applicable to All Investment Advisers

(i) Prohibited Activities Rule

(A) Limitations on Liability

The Prohibited Activities Rule prohibits a private fund adviser from seeking reimbursement, indemnification, exculpation, or limitation of liability for a breach of fiduciary duty, willful misfeasance, negligence or recklessness in providing services to the private fund.

The SEC Should Separately Analyze the Proposed Restrictions on Limitations of Liability with Respect to Advisers Act Fiduciary Duty and Local Contractual Law Duties. We believe that the SEC should separately analyze contractual provisions that seek to shape the fiduciary duty of an investment adviser under the Advisers Act as compared to those that seek to shape the duties of the general partner, manager or other persons under the contract law of the applicable jurisdiction (or other equivalent laws or regulations). This is important because (i) the nature of the duties under the Advisers Act and contract law vary dramatically from each other, including the extent to which they are permitted to be shaped, modified or eliminated; (ii) the private rights of action under the Advisers Act and local contract law are substantially different; (iii) the nature of the duties under contract law vary materially between different jurisdictions (including both among U.S. states but also between the U.S. and the many non-U.S. jurisdictions); (iv) the definitions and interpretations of the terms (*e.g.*, "willful misfeasance", "negligence", "recklessness") under contract law also vary materially between different jurisdictions (particularly between U.S. and non-U.S. jurisdictions) and, in some jurisdictions, it may be difficult to determine what the equivalent term should be since the applicable contract law is not based in the same Anglo-American jurisprudence and (v) the SEC's legal knowledge and authority with respect to the Advisers Act is significantly different than its knowledge of contract law across all U.S. and non-U.S. jurisdictions. The SEC has previously provided guidance on the fact that an investment

[22] Hedge Fund Adviser Registration Adopting Release at fn. 216 and the accompanying sentence.

adviser's fiduciary duty under the Advisers Act may not be waived and any provision in the Prohibited Activities Rule should be limited to implementing this guidance.[23]

Local Contract Law Generally Permits More Shaping of Duties Than the Advisers Act. A general partner of a private fund generally is permitted to shape, modify and eliminate local contractual duties to much greater extent than it is permitted (as an investment adviser) to shape its Advisers Act duties. A contractual clause may seek to limit the liability of the general partner for actions under local contract law in a manner that is permitted under the local contract law.[24] However, a limitation of the same actions may not be permitted under the Advisers Act. Therefore, it would not be misleading or a violation of current law for such clause to limit liability only with respect to liability under local contract law and not the Advisers Act.

There Are Different Private Rights of Action Under Local Contract Law and the Advisers Act. The distinction between local contract law and the Advisers Act in this way is important because the private right of action with respect to the Advisers Act is much more limited than generally exists under local contract law. Currently, the sole private right of action for an advisory client is to sue for recission of an advisory contract entered into in violation of the Advisers Act.[25] Enforcement of violations of the Advisers Act are principally the responsibility of the SEC. On the other hand, clients generally have a right of action against any violation of an advisory contract under local contract law. This distinction in rights of action is one of the reasons why local contract law allows greater modification of the contractual duties. We are concerned that the SEC may create a "back door" private right of action for all of the Advisers Act by not only restricting exculpation and indemnification clauses with respect to the Advisers Act but also under local contract law.[26]

There Are Many Different Jurisdictions in the United States and Outside of the United States With Different Contract Law. However, these restrictions of exculpation, indemnification and similar clauses under local contract law are problematic because it could expand liability in other ways due to differences in applicable contract law. We note that the SEC appears to focus solely on U.S. state law. There is an even greater amount of variation in contract law across non-U.S. jurisdictions. The SEC has made no showing or findings that would support restrictions on such clauses in all jurisdictions around the world for any investment adviser.

SEC's Expertise Is Federal Securities Laws Not Local Contract Law. This point highlights the last important reason for separately addressing Advisers Act duties and local contract law duties: The SEC is an agency with experience and expertise in the Advisers Act and other federal securities laws. It does not have the expertise or knowledge to be making restrictions on a core contractual principle like limitation of liability under contract law in jurisdictions throughout the United States and the world. This is a lesson that the SEC staff learned with respect to the anti-assignment clause requirement of Section 205(a)(2) where the SEC staff eventually stopped

[23] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Release No. IA-5248 (Jun. 5, 2019) ("Fiduciary Duty Guidance") at fn. 29 and the accompanying sentence.
[24] Private Funds Proposing Release at 150 – 151.
[25] Transamerica Mortg. Advisors, Inc. v. Lewis. 44 U.S. 11 (1979).
[26] See Private Funds Proposing Release at fns. 171 and 172 and the accompanying paragraph.

providing guidance as to what would constitute "consent" because it was a matter of local contract law.[27]

Increased Threat of Private Litigation Will Have Wide-Ranging Effects. This provision of the Prohibited Activities Rule would likely result in an increased threat of private litigation (and potential liability associated with such litigation) as a result of the expanded rights of action and limited ability to shape contractual duties discussed above. Such an increased risk of private litigation would increase the costs for investment advisers both relating to taking actions to mitigating those litigation risks and also in defending against such litigation. These effects will be wide-ranging: There will be increases to insurance premiums (or, in certain cases, an inability to get insurance). There will be increases to costs of additional internal and external legal review and support.

Threat of Litigation Will Affect Behavior of Advisers. There will also be a range of adverse behavioral consequences from the increased threat of litigation. Advisers will be less likely to make "risky" or unusual investments that may be in the best interests of the fund from a risk-reward analysis, but present different litigation risks.[28] Small investment advisers without a robust in-house legal team or other access to sophisticated ongoing legal support will be placed at a competitive disadvantage to larger investment advisers. This will lead to less competition in the investment adviser market, as fewer persons decide to start new investment adviser firms, given the increased burdens and, ultimately, a decrease in the choices for U.S. investors, particularly of smaller and newer private funds.

Threat of Litigation Will Lead to Avoidance of United States. Furthermore, non-U.S. advisers will take additional actions to not be subject to the Advisers Act, because they do not want to deal with the unnecessary Advisers Act overlay on local contract law. Non-U.S. advisers are more likely to be wary of increased legal liability risk in the United States, where they may have little knowledge or experience. This wariness would be amplified in situations where the personnel (or other persons associated with) the non-U.S. adviser is concerned about the potential for personal liability. This would likely deprive U.S. investors of the ability to access certain non-U.S. funds in certain situations or the ability of U.S. companies to access the capital of non-U.S. funds.

Negligence Standard Is Inconsistent with Other Areas of Federal Securities Laws. The limitation of liability provision of the Prohibited Activities Rule also suffers from the fact that it is inconsistent with existing federal securities law. For example, the existing standard with respect to retail investors in U.S. registered investment companies is "gross negligence."[29] Similarly, the liability standard under Rule 10b-5 under the Securities Exchange Act of 1934 requires scienter.[30] Furthermore, the SEC is not proposing any similar requirement with respect to contracts with advisory clients other than private funds, including, for example, separately managed accounts for retail clients. Applying this prescriptive requirement only with respect to private funds (whose

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[27] See, *e.g.*, American Century Companies, Inc., SEC Staff No-Action Letter (Dec. 23, 1997).
[28] See, *e.g.*, Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 Journal of Law & Economics 425-46 (1993).
[29] *See* Section 17(h) of the Investment Company Act of 1940 (requiring a limitation of liability provision for directors or officers of a registered investment company based on "willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office").
[30] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

investors are predominantly sophisticated investors, including institutional clients and high net worth individuals)[31] runs contrary to the SEC's long-standing position that sophisticated investors are better positioned to review full and fair disclosure and provide informed consent to conflicts of interest (and also hedge clauses) as compared to retail investors.[32] If Congress has determined that retail investors do not need this level of protection (as evidenced by the Investment Company Act provision), then there can be no reason to apply a higher level of protection for sophisticated investors.

Proposed Liability Limitations Are Contrary To Recent Positions on Hedge Clauses. The proposed Rule would also be inconsistent with the recently adopted guidance with respect to the Advisers Act fiduciary duty where the SEC received comments on whether to prohibit so-called "hedge clauses."[33] The SEC specifically declined to do so stating that "[t]he question of whether a hedge clause violates the Advisers Act's antifraud provisions depends on all of the surrounding facts and circumstances, including the particular circumstances of the client (*e.g.*, sophistication)."[34] Additionally, while the SEC expressed skepticism that a hedge clause for a retail client would be consistent with an adviser's fiduciary duty, the SEC stated that whether a hedge clause with an institutional client would violate the fiduciary duty depends on the facts and circumstances.[35] Given the very limited amount of time since this guidance, we see no reason for a proposal that would not merely ban hedge clauses but also impose a specified level of liability.

(B) **Adviser Clawback for Taxes**

In the context of private funds, profits are shared between the investors and carried interest recipients (typically individuals employed or engaged by the adviser) depending on the performance of the underlying investments. Private funds usually have drawdowns and distributions throughout their life, which can create situations where carried interest recipients have received more over the life of the fund than they would have received if all distributions had been made upon liquidation. In these situations, it is common for investors to negotiate a clawback of carried interest.

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[31] *See* Private Funds Rule Proposing Release at fn. 8 and the accompanying sentence ("Some of the largest groups of private fund investors include state and municipal pension plans, college and university endowments, non-profit organizations, and high net worth individuals").

[32] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Release No. IA-5248 (Jun. 5, 2019) ("Fiduciary Duty Guidance") at fn. 31 ("Such a hedge clause generally is likely to mislead those retail clients into not exercising their legal rights, in violation of the antifraud provisions, even where the agreement otherwise specifies that the client may continue to retain its non-waivable rights. Whether a hedge clause in an agreement with an institutional client would violate the Advisers Act's antifraud provisions will be determined based on the particular facts and circumstances.") *Id.* at p. 25 – 26 ("Full and fair disclosure for an institutional client (including the specificity, level of detail, and explanation of terminology) can differ, in some cases significantly, from full and fair disclosure for a retail client because institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications.")(citing In the Matter of Arleen W. Hughes, SEC Release No. 34-4048 (Feb. 18, 1948)).

[33] Fiduciary Duty Guidance at fn. 31.

[34] Fiduciary Duty Guidance at fn. 31.

[35] Fiduciary Duty Guidance at fn. 31.

Clawbacks are Often Appropriate for Dealing with Unexpected Scenarios. Clawback is an important investor protection mechanism, and is relevant for all distribution waterfall models, even for a "whole fund" waterfall. For example, take a private equity fund of €120m with 20% "whole fund" carried interest, and assume €100m is drawn for five investments of €20m each. If the first four investments are sold for €30m, then under the "whole fund" waterfall, no carried interest would be paid on the sale of the first three investments. On the sale of the fourth investment (in say year eight) the first €10m would be distributed to investors (so they have been repaid their €100m in full), and then the remaining €20m would be split 80/20 (*i.e.* €16m to investors and €4m to carryholders[36]). The "whole fund" waterfall ensures that even if the last investment were written off in year ten, there would not be a clawback (as total profits are €20m (€120m over €100m) and the carried interest holders have received 20% of that €20m.

However, there are some scenarios where a clawback could occur due to events that were not envisaged at the time of the sale of the fourth asset (and accompanying carried interest distribution). For example, (i) there may be situations where the manager believes it is beneficial to make a follow-on investment into the fifth investment, in say year nine or ten (ii) litigation costs may arise in respect of an exit of one of the first four assets that the manager believes it is prudent to pursue; or (iii) there may be situations where the terms of an exit of one of the earlier investments require amounts to be returned by investors. Therefore, while whole fund models of carried interest distribution may make a clawback much less likely, they do not always remove the possibility entirely.

It is absolutely customary in the private equity and venture capital industry, and invariably accepted as reasonable by fund investors, for carried interest holders to not be "out of pocket" in a clawback situation. The clawback is not aimed at penalising the manager or carry holders but rather to ensure carry holders do not retain "in pocket" amounts that should, on the final analysis, be paid to the investors. The carried interest typically is held by individuals employed or engaged by an adviser, who are likely to incur tax liability when they are allocated a share of profits and receive the carried interest (in year eight in the example above) and in many jurisdictions may incur tax liability earlier than that (and prior to receiving any carried interest amounts), for example, if the valuation of the fund (on a liquidation basis) means that it is likely that they will receive carried interest.

Proposed Clawbacks on a Gross of Tax Basis Creates Undue Tax Penalties for Investment Adviser Teams. We would note that describing a clawback obligation as an "overpayment" of carried interest, may imply that there was a mistake at the time of calculation; this is not the case. Carried interest waterfalls are calculated in a way to try to ensure that the relevant economics are achieved as at the liquidation of the fund. However, as demonstrated above, this can only ever be done on a 'best estimates' basis and the final position can only be known once the fund has been fully liquidated and there are no further liabilities. We do not think therefore it is appropriate to penalise the team in situations where unforeseen events result in a contractual clawback.

In the example above if a further €15m of the original €120m were to be drawn for a follow-on (example (i) above) and ultimately written-off. The situations would be:

[36] In practice there would often be a preferred return protecting investors as well, but this has been removed for simplicity.

- Overall profits of €5m (€120m over €115m)
- Investors have received €1m of profits (in addition to €115m return of capital).
- Carried interest holders have received €4m of profits
- Carried interest holders would be obliged to return €3m to investors (so that the €5m profits have been split 80/20).

In the above situation if carried interest holders were subject to, say a 30% effective tax rate, then they would have received net carried interest of €2.8m and would be out of pocket for the remainder of €1.2m. This would be a situation where investors have received a profit on the fund and yet carried interest holders have not only handed back the benefit they have received (the after-tax carry) but also effectively suffered a loss of €200,000.

Requiring carried interest to be clawed-back on a gross of tax basis can therefore be unfair and unduly burdensome on the individuals within an adviser. Given that advisers and their investors are typically in favour of carried interest being spread widely across the Adviser's team, this could be particularly burdensome on junior executives who may not have sufficient assets to repay the clawback having already suffered the tax.

Reclaiming Tax or Tax Losses is Not Possible in Many Jurisdictions. In addition, we would note that personal tax liabilities vary materially between jurisdictions. In addition to the quantum of such tax, the ability of an individual to recover tax in the event that there is a clawback obligation varies from jurisdiction to jurisdiction. It cannot be assumed that any such tax cost would be reversed, offset or reclaimable by individuals in the event that there is a clawback event, as most European tax regimes do not allow any such reclaim or offset and would not recognise any form of tax loss that could potentially be used by the individuals as a result of the clawback. In these circumstances, the tax on carried interest once triggered and due is likely to be an absolute cost which cannot be recouped directly or indirectly by the individuals who suffer it, even if there is a subsequent clawback event. Therefore, any obligation to refund carry on a gross of tax basis is likely to be disproportionately burdensome on advisers, and even more so for those with a team in diverse locations. In particular, this could disproportionately affect non-U.S. advisers if the Extraterritorial Limitations do not apply to them. This seems even more inequitable for carried interest recipients subject to a "whole fund waterfall" where carried interest returns are already delayed.

Furthermore, we are concerned that an obligation to require clawback to be returned on a gross of tax basis may encourage firms to take more conservative positions that could reduce overall returns to investors, in particular towards the end of the fund life. This could be through (i) deciding not to make follow-on investments to tail-end investments in situations where it may be beneficial to the ultimate returns to make such an investment (ii) deciding not to incur litigation or other expenses that may protect the fund's tail-end investments; (iii) retaining a greater amount of proceeds within the fund to maintain reserves to fund potential tail-end liabilities, reducing IRR to investors, and/or (iv) concentrating the carried interests in the hands of more senior executives and/or the adviser firm itself, who may be able to afford the risk of a gross of tax repayment (neither of which is attractive to investors from the perspective of proper alignment/incentivization).

Clawbacks Are Only One of a Number of Tools Available to General Partners and Investors. These tools include (i) end of life clawbacks, (ii) interim clawbacks, (iii) fund-level escrow arrangements, (iv) clawback guarantees from individuals, the adviser and/or its parent, (v) cross-collateralisation of returns in a deal-by-deal waterfall, (vi) unrealized value tests in a deal-by-deal waterfall, (vii) preferred return/hurdles, (viii) carry percentages and 'super-carry'.

This is important for two reasons (i) while clawback may be more likely in a deal-by-deal model, there may be other mechanisms in place to counteract this, and (ii) creating restrictions on the ability of investors and general partners to negotiate commercial terms for the clawback (by requiring it to be gross of tax), will likely affect the position that is negotiated on one or more of these other provisions (for example, it may result in fewer interim clawbacks or the removal of clawback altogether in favour of escrow arrangements (which are typically less attractive to both investors and the general partner)).

It is worth noting that when the Institutional Limited Partners Association ("ILPA") released its first set of principles, it advocated a similar position to the one that the SEC has proposed. However, after many discussions between advisers and investors within the industry the later sets of principles changed this position and now acknowledge that the clawback may be net of tax where it is excessively burdensome or impractical given the application to individual members of the general partner. We believe that the SEC should take a similar position and leave the decision to be determined between investors and advisers in the context of the relevant situation.

(C) Allocation of Fees and Expenses

"Unperformed" Services Are Generally a Misnomer For Payment Smoothing. With respect to payments for "unperformed" services or "accelerated payments" for monitoring and other services performed by the adviser or its affiliates for portfolio investments, the SEC may misunderstand the nature of these payments. The services performed by an adviser (or its affiliates) for a portfolio investment vary depending on the type of portfolio investment (*e.g.*, the type of company, where the company is in its life cycle, the business strategy of the company). It also varies depending on the stage in the life cycle of the fund's investment in the company. It is common to front load a lot of the services for a portfolio investment before and soon after the fund has made an investment. These upfront services can include a range of activities, including, for example, industry analyses and strategy development where the private fund adviser seeks to re-orient the portfolio investment on a more successful trajectory, business plan development and advising on group re-structurings. However, it may be in the best interests of the private fund to smooth the payment for such services over the life of the portfolio company, so that the portfolio company is not unnecessarily burdened. This smoothing may naturally end at a liquidation event when the portfolio company will have additional capital with which it can pay for the services performed by the adviser. This structure of payment is not unique to the private fund industry. There are many situations (*e.g.*, intellectual property licenses) where the bulk of the payment may be triggered by a liquidity event. For these reasons, we believe that adequate disclosure of such fees should be sufficient, otherwise the adviser may be forced to re-structure the payment of such fees in a way that is not in the best interests of the private fund.

Market Has Already Reacted to SEC Guidance on the Acceleration of Monitoring or Other Fees. We believe this rule is unnecessary because, following the SEC enforcement actions in this

area,[37] private fund advisers have either (i) moved away from charging such accelerated monitoring fees or (ii) less commonly, have provided much clearer disclosure on the existence and circumstances of such accelerated fees.

(D) Certain Fees and Expenses

SEC Has Not Shown Problems with "Pass Through" Expense Models. For most members, we do not believe there would be a significant issue with the prohibition on an adviser from charging a private fund for fees and expenses associated with a governmental or regulatory examination or investigation and regulatory compliance fees and expenses of the adviser or its related persons. However, as noted by the SEC, there are a minority of advisers who operate on a "pass through" expense model. The SEC presents no findings or evidence that such "pass through" models harm private funds or their investors, provided there is adequate disclosure and policies and procedures relating to expense allocation. We do not know why the SEC would remove a business model that in other contexts has been found to be beneficial to investors and can lead to lower fees being charged to a fund.

Confirm Interpretation That Prohibition Does Not Apply to Fund-Related Expenses. We do stress that it is important that the SEC maintain the interpretative position that would exclude from this restriction the ability to charge for regulatory, compliance and other fees and expenses directly related to the activities of the private fund. Requiring an adviser to bear these fees and expenses would harm the private fund since the adviser may be disincentivised from engaging in actions that are beneficial for the private fund, but increase the expenses borne by the adviser, or may drive fee increases.

Confirm that Fund-Related Expenses Includes Advisers Act Expenses Directly Related to the Fund. It is common practice for the fund to bear the expenses associated with engaging a custodian to maintaining its cash and securities and to engage an accountant to perform an annual audit. Both of these activities are also often used to comply with the Custody Rule. Similarly, some of the activities covered by the Private Fund Rules would overlap with activities that are usually paid for by the fund, including, for example, investor reporting in the Private Fund Quarterly Account Statements Rule, the annual audit in the Private Fund Audit Rule, the engagement of an opinion provider in the Adviser-Led Secondaries Rule, and the preparation of disclosures regarding side letter provisions in the Preferential Treatment Rule. In these situations, it is generally impossible to distinguish between regulatory and non-regulatory expenses. We request confirmation that a manager would not be required to bear these types of expenses.

(E) Non-Pro Rata Fee and Expense Allocations

Non-Pro Rata Allocations Are Not the Norm But Generally Happen to Promote Fair and Equitable Outcomes Between Funds. We disagree strongly with the proposed prohibition on the ability of an adviser to allocate fees and expenses relating to a portfolio investment (or a potential portfolio investment) on a non-pro rata basis between multiple private funds or other clients advised by the adviser (or its related persons). It is true that in the vast majority of cases when more than one affiliated fund makes an investment in the same portfolio investment that the

[37] *E.g.*, In the Matter of Blackstone Management Partners L.L.C. et al., SEC Release No. IA-4219 (Oct. 7, 2015).

expenses are allocated on a pro rata basis. In our experience, most expense allocation policies and disclosures use pro rata allocation as the default in the such cases. However, these policies and disclosures also either provide specific exceptions where this is not the case or reserve the right for an adviser to re-allocate the fees and expenses where the adviser determines a pro rata allocation is not fair and equitable to the participating funds. For example, non-pro rata fee and expense allocation may be fair and equitable where there are excused investors in one fund or where one private fund has different tax, regulatory or other reporting or other requirements that are not applicable to the other participating funds.

Conflicts Associated with Allocations Are Based With Disclosure and Informed Consent. The SEC notes that there are conflicts of interest relating to non-pro rata expense allocations and we agree. We agree that there are conflicts associated with such expense allocations. However, we believe the SEC may have failed to appreciate the diversity of investment structures that exist throughout the private fund industry. Each private fund or other client may have unique or differentiated tax, regulatory or other situations that would drive a non-pro rata allocation. A principles-based approach that relies primarily on disclosure to, and informed consent from, sophisticated investors makes the most sense where there is a lack of uniformity of how those conflicts are manifested.

Proposed Rule Would Not Create Better Allocation of "Broken Deal" Expenses for the Main Fund. The SEC seems particularly focused on the allocation of "broken deal" expenses but it also acknowledges that allocating such expenses to potential co-investors who have not entered into any contract is not possible.[38] We believe that, if adopted, this proposal would simply result in more main funds making the entire initial investment and then selling on a portion to a co-investment vehicle formed after the fact. Requiring this form would not result in any benefit to the fund, since it would remain on the hook for the entire "broken deal" expenses either way. In fact, it may be disadvantageous where holding the investment in the interim is riskier than simply admitting a newly-formed co-investment vehicle at or closer to the initial investment.

(ii) **Preferential Treatment Rule**

There Should Be a Materiality Threshold for Preferential Treatment Disclosure. The SEC should adjust the disclosure requirements with respect to all preferential treatment to provide some materiality threshold similar to the prohibitions. Investors may negotiate for different treatment where it is questionable whether it is preferential or just individualized. For example, certain investors negotiate reporting or excuse requirements to satisfy their own regulatory or legal requirements. Overwhelming investors with every instance where an investor received individualized treatment seems unnecessary.

Disclosures Made Pursuant to an MFN Process Should Satisfy the Disclosure Requirement. The SEC should adjust the rule to permit a private fund adviser to rely on its MFN process, whereby investors with MFN provisions receive information on a range of side letter or other provisions after closing. Since the MFN provisions are intended to ensure equality of treatment, it would appear unnecessary to require an investment adviser engage in a burdensome effort of completing this summary of provisions subject to MFN prior to closing.

[38] Private Funds Proposing Release at fn. 180.

We would like to note that in the European Union, the AIFMD only requires that no investor in an AIF shall obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF's rules or instruments of incorporation. We believe this approach is much more appropriate than the SEC and fits better with the realities of the industry.

(b) **Rules Applicable to Registered Investment Advisers**

(i) **Private Fund Quarterly Statements Rule**

The SEC states that the purpose of the periodic statements is to improve the ability of investors to (i) compare their private fund investments, (ii) monitor compliance with the private fund's governing agreements and disclosures, and (iii) better understand the impact of the fees and expenses on the private fund's performance.[39]

(A) General Rationale

The Purposes of the Rule Could Be Met with Less Frequent (i.e., Annual) Reporting. The SEC does not provide any basis for why the reporting should be done on a quarterly basis, particularly with respect to closed-end funds that do not permit redemptions in the ordinary course of business. Many private fund advisers provide quarterly reports to investors, but this reporting is done on an unaudited basis to reduce the burdens on the fund associated with the reporting. This level of frequency is not relevant or helpful in a private equity context, where fee and expenses provisions are negotiated and provided for in detail in the fund's constitutional documents, the investor has invested for a ten-year period, with no possibility to redeem its shares, and information on fees is not often available on a quarterly basis, or may change little from quarter to quarter.

We believe the SEC's approach should reflect the fact that there are also cases where investors in certain private funds to do not want quarterly reporting because some investors do not want the fund to bear the costs associated with quarterly reporting and do not believe information provided on a quarterly basis is necessary.

Annual figures, which are audited, and also much more reliable and give the investor a better overview of the real costs it faces. It is unlikely that many (if any) investors would engage in detailed analysis of fee and expense information on a quarterly basis either for understanding performance or for monitoring compliance with the governing documents and disclosures, particularly in the case of a closed-end fund where there are no redemptions in the ordinary course. The increased granularity of fee and expense reporting may actually be less useful for investors because the investors may be confused with the natural quarterly variations in fees and expenses through the year but also through the life of the fund. We believe that if there is to be a new requirement to disclose fees and expenses and performance that it should be tied with the traditional annual audit process in order to reduce the burdens and costs to the private fund investors. We believe that tying it to the audit process would also increase the accuracy of the statements and reduce the likelihood of errors that may lead to more investor confusion.

[39] Private Fund Rules Proposing Release at p. 18.

We believe these arguments are in themselves sufficient for the SEC to refrain from introducing quarterly reporting requirements. For additional arguments, we invite the SEC to examine the response given by our sister associations, the AIC and the BVCA.

B) Extraterritorial aspects

The SEC states that the purpose of the periodic statements is to improve the ability of investors to (i) compare their private fund investments, (ii) monitor compliance with the private fund's governing agreements and disclosures, and (iii) better understand the impact of the fees and expenses on the private fund's performance.[40]

Confirm Private Fund Quarterly Statements Rule Does Not Apply to Non-U.S. Funds of Non-U.S. Advisers. As discussed in more detail above and consistent with its long-standing position on the extraterritorial application of the Advisers Act, we request confirmation that the Private Fund Quarterly Statements Rule will not apply with respect to a non-U.S. registered investment adviser's relationship with a non-U.S. private fund. We note that other non-U.S. jurisdictions may have or may implement in the future reporting requirements with respect to private funds that could conflict with the Private Fund Quarterly Statements Rule.[41] Therefore, to prevent future conflicts of law (among other reasons), we believe there should be limited extraterritorial application of the Private Fund Quarterly Statements Rule[42].

Exclude Where Subject to Rule Solely Due to U.S. Sub-Adviser. We further believe that a non-U.S. fund should not be required to make quarterly statements in accordance with the Private Fund Quarterly Statement Rule solely because it (or its primary adviser) engages a U.S. registered sub-adviser. In many cases, the sub-adviser is not responsible for all of the private fund investments, for ensuring compliance with the private fund's governing agreements and disclosures or the allocation of the fees and expenses. It would therefore need to impose a burden on the non-U.S. primary adviser in order to comply with the Private Fund Quarterly Statements Rule. As a result, the non-U.S. primary adviser would be less likely to engage a U.S. registered adviser as a sub-adviser. We believe that the general principles of limited extraterritorial application of the Advisers Act would also apply in these situations.

(ii) **Private Fund Audit Rule**

We have a number of concerns relating to the Private Fund Audit Rule both with respect to its application to non-U.S. advisers and non-U.S. funds but also more generally. We believe that it is overly broad and unnecessary.

Confirm Audit Requirement Does Not Apply to Non-U.S. Funds of Non-U.S. Advisers. As discussed in more detail above and consistent with its long-standing position on the extraterritorial

[40] Private Fund Rules Proposing Release at p. 18.

[41] Quarterly reporting is currently not required in EU law. We note here that, while quarterly reporting was mentioned in the European Commission proposal on AIFMD, negotiations could lead to a situation where quarterly reporting would – rightly – still not be required. In this case, there would be a direct conflict of law between the EU and the US.

application of the Advisers Act, we request confirmation that the Private Fund Audit Rule will not apply with respect to a non-U.S. registered investment adviser's relationship with a non-U.S. private fund.

Confirm and Clarify Requirements Relating to U.S. GAAP Reconciliation. We support permitting non-U.S. private funds or private funds that have a non-U.S. general partner or other manager to prepare their financial statements in accordance with a standard other than U.S. GAAP.[43] We believe it is important to recognize that the predominance of other accounting standards outside of the United States and not impose a U.S. GAAP standard on funds where investors may want and be accustomed to other accounting standards. Consistent with the SEC staff's current interpretative position under the Custody Rule, we request that the Private Audit Rule permit that any reconciliations to U.S. GAAP only be included with respect to U.S. investors.[44] We believe that such a position is consistent with the fact that non-U.S. investors generally prefer and are more familiar with non-U.S. accounting standards. We do not believe that non-U.S. investors will see the value in the receipt of a U.S. GAAP reconciliation to the same extent as a U.S. investor. We further request confirmation that to the extent there are no U.S. investors, that no such U.S. GAAP reconciliation is required. We note that it would be an unnecessary expense if there are no U.S. investors to whom to deliver the U.S. GAAP reconciliation.

Remove Requirements Relating to Sub-Advised Funds. We disagree with the requirements whereby an investment adviser who does not have the requisite control over a private fund must take all reasonable steps to cause such private fund to comply with the Private Fund Audit Rule.[45] We are particularly concerned about a situation where a U.S. registered investment adviser acts as sub-adviser to a non-U.S. private fund with a primary adviser and/or general partner who is a non-U.S. adviser. Absent the presence of the U.S. sub-adviser, such private fund would not be subject to the Private Fund Audit Rule and, as discussed more fully above, no investor in such a private fund would expect it to be subject to the protections of the Advisers Act. The non-U.S. adviser would be much less likely to engage a U.S. sub-adviser if engaging such a U.S. registered adviser as a sub-adviser would cause the non-U.S. fund to be subject to the Private Fund Audit Rule. We believe that this would harm the competitiveness of U.S. advisers and limit the ability of non-U.S. investors to access the expertise of U.S. advisers, while not providing additional investor protection.

Widespread Audits by Private Funds Make Private Fund Audit Rule Unnecessary. More broadly, however, we question the necessity of the Private Fund Audit Rule given the requirements of the Custody Rule. Using the SEC's Form ADV data, well over 80% of all private funds (excluding securitized asset funds[46]) undergo an annual audit in accordance with the Custody Rule,

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[43] Private Fund Rules Proposing Release at p. 106 – 107.

[44] Staff Responses to Questions About the Custody Rule, Question VI.5 (March 10, 2010), available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm ("Custody Rule FAQ") (citing Goodwin, Proctor & Hoar, SEC Staff No-Action Letter (Feb. 28, 1997)).

[45] Private Fund Rules Proposing Release at p. 112 – 113.

[46] "Securitized asset funds" are differently structured from other private funds so present different issues relating to the Custody Rule and the annual audit. We note that, if the SEC wishes to cause more "securitized asset funds" to undergo an audit, then it should adopt a rule aimed at the unique structures of "securitized asset funds."

with more than 90% of hedge funds and private equity funds undergoing such an audit.[47] With such widespread compliance with the annual audit requirement, the Private Fund Audit Rule seems unnecessary and duplicative for over 80% of private funds.

Private Fund Audit Rule Is Not Tailored to Address the Valuation Fraud Concerns. The justification for the Private Fund Audit Rule is to verify the valuation of the private fund assets. The SEC seems particularly concerned about valuation conflicts relating to fees paid based on the value of the fund's investments and the use of valuations in fund performance presentations when obtaining new investors or fundraising for a new fund. This would mean it is unnecessary where (i) the fees of the investment adviser are not dependent on the valuation of the fund assets and (ii) the investment adviser does not use the valuations in its marketing materials. This is important because there are a range of small fund clients (*e.g.*, friends-and-family funds, employee funds) who may satisfy these conditions and for whom an audit may be costly.[48] In addition, the SEC has provided no evidence that their valuation concerns are particularly prominent with respect to the less than 20% of private funds that do not receive an annual audit. In fact, it would appear that the SEC enforcement actions relating to valuation issues were in situations where the fund was undergoing an annual audit.[49]

Private Fund Advisers Choose Not to Take the Annual Audit Approach Under the Custody Rule in Rare Occasions but for Good Reasons. The SEC already makes it very burdensome for a private fund to not use the annual audit approach under the Custody Rule and instead rely on the surprise examination approach. For example, a private fund adviser that relies on the surprise examination approach is required to (i) maintain certificated and uncertificated privately offered securities with a qualified custodian (when it is often difficult and expensive to find a qualified custodian willing to maintain an uncertificated security), (ii) have a reasonable belief that the qualified custodians are sending out quarterly account statements, which are statements of the assets held by the fund and the transactions entered into by the fund (which can result in investor confusion), (iii) provide the accountant performing the surprise examination with the contact information of investors who will be contacted during an exam to confirm that the quarterly statements they have received line up with the information on the adviser's books, and (iv) be subject to potential reporting to the SEC regarding any material deficiencies regarding its compliance with the Custody Rule.[50] The fact that it is already burdensome to not use the annual audit suggests that private funds that do not undergo such an audit usually do so for a very good reason. As noted above, one situation is for certain friends-and-family and employee funds where an audit is more costly than is desired by those types of investors. There are non-U.S. fund structures were local law requirements prevent compliance with the Custody Rule audit requirements (even taking into the account the flexibility with respect to using accounting standards other than U.S. GAAP).

SEC Is Already Notified of Modified Opinions and Changes in Accountant. The other main difference the SEC points in justifying the adoption of the Private Fund Audit Rule is the

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[47] Private Funds Proposing Release at 209.

[48] These funds may rely on the surprise examination to comply with the Custody Rule.

[49] *See*, *e.g.*, In the Matter of Swapnil Rege, SEC Release No. IA-5303 (July 18, 2019) (cited in fn. 111 of the Private Fund Rules Proposing Release as an example of valuation fraud but the release also mentions that the fund underwent an annual audit).

[50] See, *e.g.*, Custody Rule FAQ VI.1 – VI.3.

notification requirement regarding the auditor's termination or issuance of a modified opinion. This seems like an unusual reason to adopt a separate rule from the Custody Rule, as opposed to a modification of that Rule. On Part 1A of Form ADV, an investment adviser is already required to report if it has received a modified opinion and also the identity of the auditor for that fund.[51] In fact, the timing of the annual amendment of Form ADV is generally lined up to be at the same time that the accountant is issuing its opinion, and, if the annual amendment is prior to such opinion, the investment adviser is already required to make an other-than-annual amendment to reflect such opinion.[52] The SEC, therefore, would appear to already be receiving the information it is seeking to receive on a timely basis.

(iii) **Adviser-Led Secondaries Rule**

There Should Be Flexibility to Use Alternatives to Fairness Opinions. A private fund sponsor should have the flexibility to address the conflicts associated with an adviser-led secondary transaction using different methods than a fairness opinion. While fairness opinions are common in the industry, they are not the only or necessarily the most appropriate means to address the potential conflicts of interests associated with adviser-led secondary transactions. This is particularly true given that the broadness of the definition of adviser-led transactions could result in complex transactions with unique circumstances being caught within its definition in the future. Given the investor's agency in being able to accept or decline participation in the transaction, it seems the most effective method to address these conflicts in an appropriate manner is to ensure that the private fund adviser is providing full and fair disclosure concerning the conflicts and material facts associated with the transaction and receiving informed consent from the investor. If the investor has received full and fair disclosure, it can make its own decision of whether the private fund adviser's recommendation of the transaction is appropriate for them.

Furthermore, since such fairness opinions are typically an expense of the private fund, a prescriptive requirement of this type could cause certain private fund investors to bear the cost of a fairness opinion that such investors consider to be unnecessary or more expensive then other alternative methods of addressing the relevant conflict of interest.

[51] Question 23(h) of Section 7.B.(1) of Schedule D of Form ADV Part 1A

[52] Instruction under Question 23(h) of Section 7.B.(1) of Schedule D of Form ADV Part 1A ("If you check "Report Not Yet Received," you must promptly file an amendment to your Form ADV to update your response when the report is available.")