April 25, 2022

Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Re: File Number S7-03-22: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (the "**Proposed Rule**")

Dear Ms. Countryman:

The Committee on Capital Markets Regulation (the "**Committee**") appreciates the opportunity to comment on the proposed rule of the Securities and Exchange Commission (the "**SEC**") on new disclosure, reporting, audit, and conduct requirements applicable to investment advisers to private funds (the "**Proposed Rule**").[*]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-eight leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Committee respectfully submits that the Proposed Rule[1] lacks clear basis in the SEC's statutory authorities, most prominently with the prohibitions of certain indemnification clauses and the charging of certain fee and expense types. The Committee also concludes that the cost-benefit analysis in the Proposed Rule ("**CBA**") is inadequate to support such a sweeping departure from the existing private and public fund market structure.

Our letter proceeds in two parts. Part 1 describes the Proposed Rule. Part 2 analyzes the Proposed Rule from a legal and public policy perspective and assesses the CBA.

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[*] National Economic Research Associates (a part of the Oliver Wyman Group) consulted on the CBA analysis in the Committee's letter.

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,866 (Mar. 24, 2022), *available at* https://www federalregister.gov/documents/2022/03/24/2022-03212/private-fund-advisers-documentation-of-registered-investment-adviser-compliance-reviews [henceforth, the "**Proposing Release**"].

1. SUMMARY OF THE PROPOSED RULE

The Proposed Rule includes a series of new rules and amendments under the Investment Advisers Act of 1940 (the "**Advisers Act**"), as amended,[2] applicable to investment advisers to private funds. If adopted, the Proposed Rule would significantly expand the regulation of private fund advisers, including, *inter alia*, by: (i) restricting enumerated "prohibited activities" (*e.g.*, charging certain types of fees and contractually limiting private fund advisers' liability for negligence); (ii) prohibiting certain forms of "preferential treatment" extended to select investors through side letters or similar arrangements; (iii) requiring quarterly disclosures regarding fund fees, expenses, and performance; and (iv) mandating annual audits of private funds.

The SEC cites Section 211(h) of the Advisers Act as its primary authority for the Proposed Rule, which grants the SEC authority to: (i) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and (ii) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the SEC deems contrary to the public interest and the protection of investors.

Although the terms of Section 211(h) make no explicit mention of "private funds," according to the SEC, the proposed reforms are intended to "protect those who directly or indirectly invest in private funds by increasing visibility into certain practices, establishing requirements to address certain practices that have the potential to lead to investor harm, and prohibiting adviser activity that we believe is contrary to the public interest and the *protection of investors*."[3]

However, we note that direct access to investment in private funds is limited under current law to "accredited investors" (investors with a net worth of $1 million or more or $200,000 or more in income over a multi-year period)[4] or, in the case of private funds with more than 100 investors, "qualified purchasers" (investors with $5 million or more in investments and entities with $25 million or more in investments).[5] Retail investors (investors other than accredited investors and qualified purchasers) thus do not invest directly in private funds.[6] Although certain publicly offered investment funds offer retail investors limited *indirect* exposure to such private funds, they represent a very small percentage of the total capital invested in private funds. As of Q2 2021, SEC-registered investment companies represented only 1.2% of total beneficial ownership of

[2] 15 U.S.C. 80b-1 *et seq*.

[3] Proposing Release at 16,920 (emphasis added).

[4] 17 CFR sec. 230.501(a).

[5] 15 USC sec. 80a-2(a)(51).

[6] *See, e.g.*, Proposing Release at 16,935 ("Private fund investors are generally institutional investors . . . as well as high net worth individuals."); Elisabeth de Fontenay et al., *Side Letter Governance* WASHINGTON UNIVERSITY LAW REVIEW (forthcoming) at 11, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4067905 ("Most often, private investment funds escape the burdensome regulatory treatment reserved for registered investment funds by not admitting retail investors.").

private funds.[7] Moreover, such SEC-registered funds are typically limited by law in the extent to which they may allocate their assets to private funds, and a significant portion of the ownership of such SEC-registered funds is likely itself attributable to accredited (i.e., non-retail) investors.[8] Non-retail investors consist of large institutions and high net-worth individuals, that are in each case typically highly sophisticated and represented by experienced counsel. In our view, and as further discussed throughout Part 2 of this letter, the Proposed Rule and its accompanying CBA fail to substantiate on a legal, policy, or economic basis the justification for subjecting private fund advisers and such investors to the Proposed Rule's restrictions in the name of investor protection.

A. Prohibited Activities

The Proposed Rule would bar private fund advisers from engaging in certain enumerated "prohibited activities" that the SEC believes are contrary to the public interest and the protection of investors.[9] These activities are prohibited regardless of any disclosure or informed waiver, or consent provided by investors, any authorities contained in a private fund's organizational documents, and whether performed directly or indirectly by the adviser.[10]

For example, the Proposed Rule would prohibit a private fund adviser from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, *negligence*, or recklessness in providing services to the private fund.[11]

The Proposed Rule would also prohibit private fund advisers from charging certain fees and expenses to a private fund or portfolio investment. In particular, it would prohibit private fund advisers from charging fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, as well as regulatory and compliance fees and expenses of the adviser or its related persons.[12] In addition, the Proposed Rule would prohibit private fund advisers from charging fees and expenses related to a portfolio investment on a non-*pro rata* basis when multiple private funds and other clients advised by the adviser have invested (or propose to invest) in the same portfolio investment.[13]

Under the Proposed Rule, private fund advisers are also prohibited from reducing the amount of any "adviser clawback" (i.e., an adviser's obligation to pay back interim performance compensation that, because of subsequent asset value changes, ultimately exceeds the adviser's compensation entitlement as finally calculated) by the amount of certain taxes. Such a reduction

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[7] *See* U.S. SEC. & EXCH. COMM'N, Private Fund Statistics (Jan. 14, 2022), *available at* https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2021-q2.pdf.

[8] *See* COMMITTEE ON CAPITAL MARKETS REGULATION, *Expanding Opportunities for U.S. Investors and Retirees: Private Equity* (Oct. 2018), https://www.capmktsreg.org/2018/10/30/expanding-opportunities-for-u-s-investors-and-retirees-private-equity/.

[9] Proposing Release at 16,920.

[10] *Id*.

[11] *Id*. at 16,925.

[12] *Id*. at 16,922.

[13] *Id*. at 16,925.

is common in existing private fund clawback arrangements. The Proposed Rule would also prohibit private fund advisers from borrowing money, securities, or other fund assets, or receiving a loan or extension of credit, from a private fund client.[14]

B. Preferential Treatment

If adopted, the Proposed Rule would prohibit all private fund advisers—irrespective of registration status—from providing certain types of "preferential treatment" to select investors and not others.[15] According to the SEC, this proposal is intended to protect investors by prohibiting specific forms of preferential treatment that have a "material negative effect on other investors in the private fund or in a substantially similar pool of assets."[16]

Under the proposal, private fund advisers would be prohibited from providing preferential terms to certain investors regarding redemption or information about portfolio holdings or exposures, if the adviser reasonably expects that providing such terms would have a material, negative effect on other investors.[17] The proposal would also prohibit these advisers from providing any other preferential treatment to any investor in the private fund unless specifically disclosed to prospective and current investors in writing.[18] "Preferential" is not defined in the Proposed Rule, and the question of whether a particular term is "preferential" would depend on the facts and circumstances.[19] These provisions would reshape side letter practices that prevail in the private fund industry, through which private fund managers and investors routinely arrange negotiated terms with some investors that are different from those with other investors.

C. Quarterly Statement Disclosure

The Proposed Rule would require private fund advisers to prepare a quarterly statement containing specified information on fund fees, expenses, and performance for each private fund that it advises and distribute such statement to fund investors within 45 days of each calendar quarter end.[20] According to the SEC, these periodic, "plain English" statements would better allow investors to assess and compare their private fund investments and would improve their ability to monitor advisers to ensure compliance with the fund's governing agreements and disclosures.[21]

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[14] *Id*. at 16,927.

[15] *Id*. at 16,928.

[16] *Id*. at 16,928. Under the Proposed Rule, "substantially similar pool of assets" means "a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons." *Id*. at 16,929.

[17] *Id*. at 16,928.

[18] *Id*.

[19] *Id*.

[20] *Id*. at 16,890. The quarterly statement requirement would apply to investment advisers to private funds that are either registered with the SEC or subject to a requirement to register.

[21] *Id*.

a. Fees and Expenses Disclosure

Under the Proposed Rule, quarterly statement disclosure with respect to fees and expenses would be required at the (i) private fund level and (ii) portfolio investment level.

i. Private Fund-Level Disclosure

The Proposed Rule would require private fund advisers to disclose specified fee and expense information in tabular format, including: (i) a detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the private fund during the reporting period; and (ii) a detailed accounting of all fees and expenses paid by the private fund during the reporting period.[22]

ii. Portfolio Investment-Level Disclosure

Quarterly statements must also include a table with information on the fund's "covered portfolio investments," including entities and issuers that the fund invests in directly, as well as indirect investments via subsidiaries, special purpose vehicles, *etc*.[23] The table must provide (i) a detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period; and (ii) the private fund's ownership percentage of each covered portfolio investment as of the end of the reporting period.[24]

b. Performance Disclosure

The Proposed Rule would also mandate new standardized disclosures regarding a private fund's performance.[25] The proposing release states that "it is essential that quarterly statements include performance in order to enable investors to compare private fund investments and comprehensively understand their existing investments and determine what to do holistically with their overall investment portfolio."[26]

The specific disclosures required would depend on whether the fund meets the Proposed Rule's definition of a "liquid fund" or an "illiquid fund." An "illiquid fund" is one that "(i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor's request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments."[27] Examples of illiquid funds would include private equity, real estate, and venture capital funds. By contrast,

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[22] *Id*. at 16,893.

[23] *Id*. at 16,896.

[24] *Id*.

[25] *Id*. at 16,900.

[26] *Id*.

[27] *Id*. at 16,901.

a "liquid fund" would be any fund that does not satisfy the definition of "illiquid fund."[28] According to the SEC, most hedge funds would fall into the liquid fund category.[29]

Liquid funds would be required to disclose the following performance metrics:

i. annual net total returns for each calendar year since inception;

ii. average annual net total returns over the one-, five-, and ten- calendar year periods; and

iii. cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.[30]

Illiquid funds would be required to disclose the following performance measures on a quarterly basis, calculated since inception and without reflecting the impact of any fund-level subscription facilities:

i. Gross internal rate of return and gross multiple of invested capital for the illiquid fund;

ii. Net internal rate of return and net multiple of invested capital for the illiquid fund; and

iii. Gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.[31]

D. Mandatory Audit Requirement

If adopted, the Proposed Rule would require private fund advisers to obtain an audit of the private funds they manage at least annually and upon liquidation.[32] These audits must conform to various requirements set forth in the Proposed Rule. For example, each audit must be performed by an independent public accountant and audited financial statements must be distributed to investors promptly after the audit is completed.[33] The SEC states that such audits would protect against the misappropriation of fund assets and serve as a check on the valuation of private fund assets.[34]

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[28] *Id*.

[29] *Id*.

[30] *Id*. at 16,902.

[31] *Id*. at 16,903.

[32] *Id*. at 16,911.

[33] *Id*.

[34] *Id*.

2. ANALYSIS OF THE PROPOSED RULE

Section 2 analyzes the Proposed Rule from three perspectives. Subsection A reviews the Proposed Rule from a legal perspective. Subsection B reviews the Proposed Rule from a public policy perspective. Subsection C evaluates the Proposed Rule's cost-benefit analysis (as defined above, the "**CBA**"), finding that the CBA fails to substantiate certain purported benefits and to consider or quantify several principal costs of its proposals.

Shortcomings in the CBA are a serious concern because under the National Securities Markets Improvement Act of 1996, the SEC is required "to promote efficiency and capital formation in the financial markets," and "[w]henever . . . the [SEC] is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the [SEC] shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[35]

The U.S. Court of Appeals for the District of Columbia Circuit (the "**D.C. Circuit**") has held that the statutory language of the Administrative Procedure Act ("**APA**") imposes an obligation on the SEC to weigh the costs and benefits of proposed regulation, and to quantify those costs and benefits where possible.[36]

In *Chamber of Commerce v. SEC (2005)*, the D.C. Circuit considered the validity of an SEC rule requiring that mutual fund boards be composed of no less than 75% independent directors and be chaired by an independent director. The court found that the proposed rule violated the APA because the SEC had failed to "adequately consider the costs mutual funds would incur in order to comply with the [proposed rule]"[37] and rejected the SEC's contention that such costs were not practically quantifiable.[38] Similarly, in *Business Roundtable v. SEC (2011),* the D.C. Circuit remanded an SEC rulemaking on shareholder proxy access due to inadequate economic analysis, including a failure to quantify the costs of the rulemaking.[39] The court found that the SEC "inconsistently and opportunistically framed the costs and benefits of the rule" and "failed adequately to quantify the certain costs of its proposed rule or to explain why the those costs could not be quantified."[40] For these and other reasons, the court found that the proposed rule violated the APA.

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[35] National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

[36] *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005); *see also* Paul Rose & Christopher Walker, *The Importance of Cost-Benefit Analysis in Financial Regulation*, CTR. FOR CAPITAL MKTS. COMPETITIVENESS 24–33 (2013), *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/CBA-Report-3.10.13.pdf.

[37] *Chamber of Commerce*, 412 F.3d at 136.

[38] *Id*. at 143.

[39] *Bus. Roundtable v. SEC*, 647 F.3d, 1144 (D.C. Cir. 2011).

[40] *Id*. at 1148-49.

A. Legal Analysis

a. The Proposed Rule lacks statutory authority.

The Committee respectfully submits that the SEC lacks statutory authority to promulgate the Proposed Rule. Per the proposing release, the SEC's authority to regulate in this area rests upon the agency's reading of Advisers Act Section 211(h), enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[41] which states that the SEC shall:

> (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and
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> (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.[42]

Section 211(h) has generally been understood to authorize the SEC specifically to regulate broker-dealer conduct and to harmonize investment adviser and broker-dealer standards, not as a general authorization for the SEC to regulate markets more broadly. Indeed, the only prior proposed rulemaking to cite this statutory provision as authority was the controversial "sales practice" rules relating to funds' use of derivatives and due diligence of retail investors, which the SEC subsequently abandoned.[43] However, the proposing release does not provide an analysis of how or why the Proposed Rule effectuates congressional intent in adopting Section 211(h), and several of the Proposed Rule's provisions do not stand in an obvious relationship to this grant of authority.

The Proposed Rule would represent a significant expansion of the application of Section 211(h). An indemnification provision is not a "simple and clear disclosure" (under Section 211(h)(1)), nor has Section 211(h)(2)'s reference to "sales practices, conflicts of interest, [or] compensation scheme" yet been applied or interpreted to prohibit indemnification provisions or the passing through of certain fee and expense types. Moreover, the application of Section 211(h) to private fund managers would be inconsistent with the statutory objective, which was evidently to protect retail investors. Most notably, when the Treasury Department report that instigated the reform that would become Section 211(h) concluded that new legislation should prohibit "certain conflicts of interest and sales practices that are contrary to the interest of investors," the Treasury Department's proposal was explicitly premised on the goal of protecting "retail" investors. Among other references, the Treasury Department's report notes that the proposal is necessitated by the fact that

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[41] Dodd-Frank Wall Street Reform and Consumer Protection Act, section 913(h), Public Law 111–203, 124 Stat. 1376 (2010).

[42] 15 U.S.C. § 80b–11(h).

[43] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, 85 Fed. Reg. 4,446 (Jan. 24, 2020); Use of Derivatives by Registered Investment Companies and Business Development Companies, 85 Fed. Reg., 83,162, 83,164 ("We are not, however, adopting the proposed sales practices rules.").

"retail investors face a wide array of investment products" and are "often confused about the differences between investment advisers and broker-dealers."[44] This intended focus on retail investors is also evidenced in the 2009 remarks by then-SEC Chair Mary Shapiro when she indicated that the "broker-dealers" and "investment advisers" to be regulated by the rule that ultimately became Section 211(h) were those that "provide financial services to retail investors."[45] The Proposed Rule would not advance the goal of protecting retail investors since, as described above, the investors negotiating the provisions with advisers that would be covered by the Proposed Rule are not retail investors, but rather sophisticated institutional and high-net worth investors. Even assuming non-retail investors were the intended subject of Section 211(h), as further discussed in this letter, this proposal arguably *undermines* the statutory objective of transparency by incentivizing the passing on of such fees and expense types to investors as part of a non-specific management fee as opposed to a fully disclosed pass-through basis.

The Committee suggests that the SEC should revisit the question of its authorities to adopt the various proposals in the rule and to reconsider whether Section 211(h)'s relatively limited grant is appropriately applied to the subject at hand.

b. The Proposed Rule interferes with state contract law.

Several provisions of the Proposed Rule—principally in connection with the various "prohibited activities"—pertain to matters of contract law that are traditionally considered matters of state jurisdiction under the U.S. constitutional framework. While the SEC's jurisdiction in some cases overlaps with state regulatory jurisdiction (*e.g.*, in connection with the corporate proxy process, which is governed by state law but also regulated heavily under the federal securities statutes), the agency has generally sought to avoid direct conflicts with or preemptions of state law absent a clear congressional mandate. Here, the SEC is exposing itself to potential litigation risk over federalism concerns in service of protecting highly sophisticated and institutional limited partners of private investment funds,[46] whose ability to fend for themselves on the basis of *caveat emptor* has been understood for decades.

In such circumstances, the argument for preempting state contract law and otherwise limiting the freedom of contract is at its weakest and a distraction from the SEC's broader investor protection mission, which rightly places the focus on retail investors. As noted above, retail investors do not have direct access to private funds under current law, and to the extent they have indirect exposure to such funds through publicly offered investment companies, such exposure represents a very small portion of the total investor capital committed to private funds.

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[44] DEPARTMENT OF THE TREASURY, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* 71 (2009), *available at* https://fraser.stlouisfed.org/title/financial-regulatory-reform-5123.

[45] *See* Speech by SEC Chairman: Address before the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009), *available at* https://www.sec.gov/news/speech/2009/spch061809mls-2.htm.

[46] *See, e.g.*, Proposing Release at 16,935 ("Private fund investors are generally institutional investors . . . as well as high net worth individuals."); De Fontenay, *supra* note 6 at 49 ("Outside counsel for private equity sponsors and investors tend to draw from a very small set of elite law firms that specialize in private equity practice.").

The Committee respectfully submits that Section 211(h) is a thin reed on which to base prohibitions on otherwise permissible commercial terms negotiated at arm's-length between sophisticated parties in accordance with state law.

B. Policy Analysis

The Proposed Rule is discordant with the private/public distinction that has underpinned U.S. federal securities law since its inception in the 1930s and 1940s. This distinction between public and private markets is embodied throughout the SEC's statutes, whether in the exemption for "transactions by an issuer not involving any public offering" in Section 4(a)(2) of the Securities Act of 1933, as amended,[47] or the various exemptions from the definition of "investment company" under Section 3(c) of the Investment Company Act,[48] or the numerous circumstances in which accredited investors are distinguished from retail investors on investor protection grounds. Sections 3(c)(1) and 3(c)(7) of the Investment Company Act in particular reflect a specific intention on the part of Congress to define and delineate a sharp distinction between private and public funds markets, a distinction that would be eroded by the Proposed Rule.

In the Committee's view, the Proposed Rule's departure from prior understandings of the private funds market is sufficiently significant that the Proposed Rule should have been preceded by a concept release containing an extended and detailed discussion of the precise market failures that give rise to a need to police *private* markets as much as *public* markets, or more stringently than public markets (by prohibiting indemnification for gross negligence by private fund advisers while equivalent public fund regulations prohibit only indemnification for ordinary negligence). Neither the description of the proposal nor the cost-benefit analysis set forth in the proposing release sheds light on this central feature of the rulemaking.

The Committee would like to highlight five specific policy concerns raised by the Proposed Rule:

a. The proposed ordinary negligence standard for private funds is harmful and exceeds the requirements for public funds and is thus illogical as a policy matter.

If adopted, the Proposed Rule would prohibit a private fund adviser from "seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, ***negligence***, or recklessness in providing services to the private fund."[49] By comparison, the Proposed Rule stands in sharp contrast to *public* funds regulated under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"),[50] Section 17 of which prohibits—by congressional mandate—contractual provisions that would protect an investment adviser from liability to the fund for "willful

[47] 15 U.S.C. § 77d(a)(2).

[48] 15 U.S.C. § 80a–3(c).

[49] 87 Fed. Reg. at 16,920 (emphasis added).

[50] 15 U.S.C. §§ 80a-1 *et seq*.

misfeasance, bad faith, or ***gross negligence***, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract or agreement."[51]

Invariably, the public/private distinction discussed above has rested on the rationale that sophisticated counterparties are not in need of the same degree of protection as retail investors. Even where the SEC has concluded that sophisticated investors are due certain investor protections, it is perverse to mandate that such parties receive *more* protection than retail investors, as the Proposed Rule's substitution of "negligence" for "gross negligence" would suggest.

Moreover, the costs of the Proposed Rule will undoubtedly fall squarely on the shoulders of the very investors the rulemaking purports to protect, as the inevitable hikes in insurance costs to protect against liability for negligence will inevitably be passed down to the end investor through adjustments to private fund management fees. As further addressed in Part 2(C) of this letter, the CBA fails to quantify these costs.[52]

To the extent that the SEC remains committed to intervening with respect to privately negotiated contractual terms, the Committee respectfully recommends, at a minimum, that the SEC bring this provision in line with public funds and prohibit indemnification provisions with respect to *gross*, rather than merely *ordinary*, negligence.

b. The proposed prohibition on charging certain fees and expenses associated with regulatory examinations and enforcement investigations would serve to *decrease* fee transparency for investors.

While citing as authority a provision that enjoins the SEC to "facilitate the provision of simple and clear disclosures," the proposed prohibition of charging certain fees and expenses associated with regulatory examinations and enforcement investigations may, perversely, have the opposite effect.

As the proposing release itself appears to concede in a footnote,[53] even were the Proposed Rule to be adopted, private fund advisers would be permitted to restructure their expense model to cover this category of expenses as part of a general hike in management fees. In other words, the proposing release acknowledges that fees and expenses associated with a private fund adviser's regulatory obligations will, in all likelihood, be passed on to fund investors, yet the release does not provide any reasoned explanation for why one expense model is preferable to the other, let alone why there is a public interest in ensuring that one model is *per se* prohibited. Indeed, by encouraging the very real expenses associated with examinations and other regulatory activities to be rolled into a non-specific management fee structure, the Proposed Rule would arguably

[51] 15 U.S.C. § 80a–17(i) (emphasis added).

[52] Proposing Release at 16,951 ("These benefits may be diminished to the extent that advisers are able to obtain alternative permissible sources of compensation for these expenses from investors (for example, from increased management fees), although this ability would likely be limited.").

[53] Proposing Release at 16,922, n. 157 ("Certain private fund advisers utilize a pass-through expense model where the private fund pays for most, if not all, expenses, including the adviser's expenses, but the adviser does not charge a management, advisory, or similar fee. We recognize that this aspect of the proposed rule would likely require advisers that pass on the types of fees and expenses we propose to prohibit to re-structure their fee and expense model.").

obfuscate the costs associated with regulation and may even incentivize some advisers to underinvest in regulatory compliance functions for lack of any direct means to recoup costs.

Moreover, the scope of the prohibition is unclear. The Proposed Rule's reference to "compliance" expenses could potentially encompass a varying array of items, and fund advisers may interpret the scope of the term differently, thus further reducing transparency for investors regarding the types of expenses that they may bear.

The Committee respectfully suggests that there is no compelling public interest in policing the commercial terms and risk-sharing between sophisticated parties in the private funds market, but to the extent that it chooses to do so, the SEC should carefully assess the effects of the Proposed Rule on fee transparency for investors with respect to regulatory and enforcement costs.

c. The Proposed Rule's tax clawback provision misidentifies the role of net-of-tax clawbacks and fails to consider the likely consequences of prohibiting such terms.

The SEC observes that many private funds feature "clawback" mechanisms whereby an adviser must restore distributions or payments received from clients that, as a result of asset value fluctuations, exceed the adviser's due compensation under the fund's governing agreements as finally calculated.[54] Because the adviser is commonly required to pay tax on such payments from clients, many clawback mechanisms reduce the amount the adviser is required to restore to the client by the amount of such taxes (i.e., a "net-of-tax" clawback). The Proposed Rule would therefore prohibit the reduction of clawbacks by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners with respect to performance-based compensation.[55]

However, the Proposed Rule fails to understand that advisers are required to pay taxes on any compensation received from clients and the prohibition of a net-of-tax clawbacks will therefore result in the forced reallocation of the risks of tax obligations in a less efficient manner. For example, parties may ultimately negotiate fund agreements that lack clawbacks altogether or reduce the amount of clawbacks by fixed percentages intended to approximate the adviser's tax burden, which could overestimate the adviser's taxes. Both such scenarios place investors in a worse position *ex ante* compared to a net-of-tax clawback.

The Committee therefore advocates for removal of the proposed prohibition on net-of-tax clawbacks from the final rule.

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[54] *Id*.

[55] The Proposed Rule defines "**adviser clawback**" to mean "any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements." "**Performance-based compensation**" is defined as "allocations, payments, or distributions of capital based on the private fund's (or its portfolio investments') capital gains and/or capital appreciation." *Id*. at 16,923.

d. The Proposed Rule's prohibition on preferential terms underestimates the sophistication of private fund investors and may well harm smaller investors.

The Proposed Rule characterizes its prohibition on certain preferential terms as a protection for smaller investors.[56] However, as noted above, private fund investors are typically large institutions and high net worth individuals with the assistance of experienced legal counsel. The Proposed Rule does not substantiate a need to protect such investors by restricting the side letter terms that they negotiate with fund advisers in respect of redemptions or otherwise. In fact, the prohibition on preferential terms in respect of redemptions could instead harm investors with smaller ownership interests. The Proposed Rule assumes that advisers provide larger investors with better redemption terms.[57] However, advisers may instead provide more favorable redemption terms to investors with relatively smaller investments, since the cost to the fund of providing liquidity with respect to smaller stake in the fund is generally less in comparison to a larger investment. By requiring equal redemption terms, the Proposed Rule could thus result in advisers providing certain investors with relatively smaller ownership stakes with *worse* redemption terms than they currently enjoy.

e. The Proposed Rule lacks a grandfathering provision for existing private fund agreements.

The Proposed Rule does not appear to contemplate a grandfathering provision whereby *existing* private fund agreements struck between private fund advisers and their incumbent investors would be permitted to continue for the duration of their respective terms. Upsetting the settled expectations of contracting parties by prohibiting existing provisions that were negotiated in good faith by private fund advisers and their investors is an extreme position. In the worst-case scenario, depending on the precise commercial arrangements struck between advisers and investors in particular cases, the Proposed Rule could conceivably lead to the invocation of *force majeure* and change of law provisions in thousands of fund formation documents. Provoking renegotiations of existing fund agreements is extremely costly and would disrupt private fund markets. Doing so is therefore inconsistent with the SEC's mission of promoting well-ordered markets.

The Committee respectfully requests that the SEC consider including a grandfathering provision for existing private funds to the extent that it seeks to proceed with promulgating the Proposed Rule.

C. CBA Analysis

The Proposed Rule's CBA fails to consider or quantify several principal benefits and costs of its proposed restrictions and requirements.

The CBA indicates that there is a lack of data on, among other things, (i) "the extent to which advisers engage in certain of the activities that would be prohibited under the proposed rules",[58]

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[56] *Id*. at 16,929.

[57] *Id.* ("For example, a large investor may negotiate, through a side letter or other side arrangement, to be able to redeem its interest in the fund before, or more frequently than, other investors.").

[58] *Id*. at 16,948.

and (ii) "how and to what extent the changed business practices of advisers would affect investors, and how advisers may change their behavior in response to these prohibitions."[59]

In the absence of such data, it is unclear how it was determined that there is sufficient need in the marketplace for the Proposed Rule's restrictions and requirements. On the contrary, there is in fact significant empirical evidence showing that (i) the benefits of similar measures taken in other similar marketplaces have resulted in considerable costs, many of which were unanticipated and unintended, suggesting that the Proposed Rule could well have similar effects, and (ii) the market for the services of private fund managers plays a unique and beneficial role in capital markets as a whole, and that the Proposed Rule could negatively affect private fund managers and investors in private funds.

The CBA fails to consider or quantify these potential limitations and costs, which are discussed in further detail below. Section A identifies certain unconsidered factors that undermine the SEC's analysis of the costs and benefits of the proposed rules generally. Sections B through E review costs and benefits that were not considered or quantified specific to each of the Proposed Rule's (B) prohibition on certain indemnification and limited liability provisions, (C) prohibition of the pass-through of certain fees and expenses, (D) prohibition of net-of-tax clawbacks, and (E) required quarterly disclosure statements.

a. The CBA is not based on an accurate understanding of the private funds market and fails to consider how that market will react to the Proposed Rule, which results in a general overestimation of benefits and underestimation of costs.

As a general critique, the CBA in numerous instances fails to base its estimation of benefits on an accurate description of the private funds market or fails to consider how the Proposed Rule would interact with certain structural factors inherent in the private funds market to produce additional costs for market participants.

i) The CBA is based on an incomplete understanding of the relative bargaining power of fund managers and investors.

The CBA assumes that private fund advisers have superior bargaining power relative to investors and thus the SEC must prohibit certain terms that were negotiated between investors and private fund advisers.[60] The SEC's assessment of the benefits and costs of the proposal are based on this premise. However, this premise is not consistent with recent empirical studies on this topic: There is strong evidence that investors in private funds commonly have comparable bargaining power relative to advisers, and that the ability to negotiate terms is an overall value-enhancing factor in the private funds marketplace.

De Fontenay (2022) analyzed a broad sample of PE buyout fund side letters terms and found that the terms of side letters were overall beneficial for investors and typically accommodate an

[59] *Id*.

[60] *Id*. at 16,943.

investor's specific regulatory and tax concerns.[61] Clayton (2017) found that the terms negotiated by investors in private funds are generally efficiency-enhancing.[62] Moreover, an empirical analysis of private equity fund performance conducted by the National Bureau for Economic Research (2012) evidenced an equilibrium in which compensation terms are designed to reduce agency problems and reward the productivity of manager skills, and in which managers with higher compensation earn back their pay by delivering higher gross performance.[63]

ii) The CBA does not substantiate the existence of a failure of the private funds marketplace to serve fund investors.

In various instances the CBA suggests the existence of a generalized failure in the private funds marketplace to serve the needs of fund investors, which failure warrants intervention in the form of the Proposed Rule. For example, to substantiate the existence of benefits from its prohibition on undisclosed preferential terms, the CBA suggests that many private fund investors "may simply be unaware of the types of contractual terms that could be negotiated."[64] The CBA also asserts in support of the "prohibited practices" rules that "it may be hard even for sophisticated investors with full and fair disclosure, to understand the future implications of terms and practices related to these practices at the time of investment and during the investment."[65] However, the CBA cites no evidence indicating that investors in private funds are failing to effectively negotiate in their own best interests and if so, which specific investors are failing to do so. In fact, the evidence is that private fund investors are typically large institutions and high net worth individuals advised by the most sophisticated law firms which are generally intimately familiar with market standard fund terms and possible variations thereon.[66] The lack of evidence for the view that the private funds market has systematically failed fund investors pervades the CBA's analysis and casts doubt on the CBA's assessment of the benefits of the proposed rule.

iii) *The CBA fails to consider the costs of reallocating capital and renegotiating fund documents*.

The CBA appears to contemplate in certain places that existing fund documents would need to be amended to come into compliance with the proposed rules – that is, they would not be grandfathered – and that some investors might withdraw from such funds, especially if they lose

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[61] *See* De Fontenay, *supra* note 6 at 6.

[62] *See* William W. Clayton, *Preferential Treatment and the Risk of Individualized Investment in Private Equity* 11 VIRGINIA LAW & BUSINESS REVIEW 249 (2017), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2746725.

[63] *See* David T. Robinson & Berk A. Sensoy, *Do Private Equity Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance* NBER Working Paper Series No. 17942 (2012), *available at* https://www nber.org/papers/w17942.

[64] Proposing Release at 16,938.

[65] Proposing Release at 16,937.

[66] *See, e.g.*, Proposing Release at 16,935 ("Private fund investors are generally institutional investors . . . as well as high net worth individuals."); De Fontenay, *supra* note 6 at 49 ("Outside counsel for private equity sponsors and investors tend to draw from a very small set of elite law firms that specialize in private equity practice.").

preferential treatment. The CBA indicates that it anticipates that "investors withdrawing from a fund because of a loss of preferential treatment would redeploy their capital elsewhere, and so new advisers would have a new pool of investment capital to pursue."[67] However, the CBA fails to identify or quantify the transaction costs associated with such reallocation of capital, as well as costs associated with renegotiation of other fund document terms in scenarios where advisers and investors must negotiate a withdrawal of the affected investors or otherwise revise fund documents to comply with the Proposed Rule. The costs of renegotiating complex contracts are well known.[68]

iv) The purported benefits, and potential costs, to capital formation are not quantified or substantiated.

The CBA suggests that potential private fund investors are deterred from investing in private funds because of the practices that the proposed rule would prohibit and that the proposal would thus contribute to capital formation via private funds. The CBA however does not cite any evidence suggesting that there is an overall under-allocation of capital to the types of private fund that would be subject to the proposal. In fact, the available evidence suggests that there is substantial amount of investor capital seeking the services of private fund managers.[69] The imposition of higher compliance costs and more restrictive operating terms may impede the creation of newer, especially smaller, fund complexes that would otherwise serve this investor demand.

b. The CBA fails to identify and quantify the potential costs of prohibiting indemnification and liability limitation provisions

The CBA fails to consider the significant body of empirical research showing that where private parties are permitted to limit their liabilities to one another by contract, wealth is generally enhanced, both on an overall basis and with respect to the party that accepts the limitation on its counterparty's liability, including in the context of a fiduciary relationships. The CBA also fails to consider or quantify the risk that by prohibiting certain contractual liability limitations and indemnification, fund advisers and investors may seek alternative methods of re-allocating risk,

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[67] Proposing Release at 16,956.

[68] *See, e.g.*, Luca Anderlini & Leonardo Felli, *Costly Bargaining and Renegotiation*, Theoretical Economic Workshop Discussion Paper No. TE/98/361 (1998), *available at* http://eprints.lse.ac.uk/3592/1/Costly_bargaining_and_renegotation.pdf; Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation* 56 ECONOMETRICA 4 (1988) https://www.jstor.org/stable/1912698.

[69] *See, e.g.*, THE ECONOMIST, *Investors rely more and more on higher returns from private markets* (Feb. 26, 2022), *available at* https://www.economist.com/special-report/2022/02/23/investors-rely-more-and-more-on-higher-returns-from-private-markets; IBISWORLD, *Hedge Fund Industry in the US (Market Research Report)* (Nov. 2, 2021), *available at* https://www.ibisworld.com/united-states/market-research-reports/hedge-funds-industry/; Alicia McElhaney, *Demand for Hedge Funds is Rising. These Are the Strategies Investors Like Most*, INSTITUTIONAL INVESTOR (Mar. 9, 2021), https://www.institutionalinvestor.com/article/b1qwqbnn660gnd/Demand-for-Hedge-Funds-Is-Rising-These-Are-the-Strategies-Investors-Like-Most; Patrick Henry et al., *The growing private equity market*, DELOITTE (Nov. 5, 2020), https://www2.deloitte.com/us/en/insights/industry/financial-services/private-equity-industry-forecast html (finding that "demand for PE funds is increasing as high returns and perceived low volatility continue to drive inflows from both existing and new institutional investors"); MOONFARE, *Three Private Equity Trends for 2021* (Jan. 6, 2021), https://www.moonfare.com/blog/three-private-equity-trends-for-2021 ("Investors hunt for returns and find private equity. The asset class continues to outperform public markets.").

including by way of insurance, which may be more costly or otherwise less efficient and the costs of which may directly or indirectly be passed on to investors, as discussed further below.

There is a significant body of empirical research indicating that the ability of private parties, including fiduciaries, to contractually limit their liability, whether through indemnification provisions, liability limitations, and/or insurance policies, can increase efficiency and enhance value, and that by voluntarily forgoing the right to sue a fiduciary as part of an arm's-length bargaining process or investment decision, investor wealth can be enhanced.[70]

There are two seminal studies on the benefits of such limited liability provisions. Brook (1994) found that the adoption by corporations of director liability limitation provisions was associated with positive stock price reactions[71] and Bhagat (1987) found that directors and officers liability insurance increase shareholder wealth.[72] More recently, Masulis (2020) found that the adoption of "Universal Demand" statutes by states (which have the effect of lowering the risk to directors of incurring un-indemnifiable damages from shareholder suits) had a positive effect on recruiting and retaining high-quality outside directors that enhance firm value.[73]

Though the availability of insurance or other alternative risk redistribution mechanisms may partially mitigate the consequences of prohibiting indemnities and limitation of liability provisions, the compelled transition to and use of such methods may result in overall inefficiencies relative to the wider array of options currently available to market participants. Moreover, larger private fund advisers might have greater power to negotiate lower liability insurance premiums and the ability to spread those lower premiums across a larger investment base relative to smaller advisers. In this respect the proposal might unintentionally favor larger advisers. The CBA does not identify or attempt to quantify these costs.

The CBA also does not consider the possibility that private fund advisers may no longer offer certain innovative investment strategies due to an inability to limit liability for such strategies. Indeed, Guan et. al (2022) find that prohibiting managers and investors from freely negotiating

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[70] *See, e.g.*, Maria Gutierrez Urtiaga, *A Contractual Approach to the Regulation of Corporate Director's Fiduciary Duties* CEMFI Working Paper No. 0013 (2001), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=257593 (finding that the adoption of measures to protect directors for sanctions for breaches of fiduciary duties, such as indemnification protection, allows shareholders to dissociate the preventive and compensatory functions of fiduciary duties and to adapt rules to the characteristics of the corporation or its directors).

[71] Yaron Brook & Ramesh K. S. Rao, *Shareholder Wealth Effects of Directors' Liability Limitation Provisions*, 29 JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS 3 (1994), *available at* https://www.jstor.org/stable/2331341.

[72] Sanjai Bhagat et al., *Managerial Indemnification and Liability Insurance: The Effect on Shareholder Wealth*, 54 THE JOURNAL OF RISK AND INSURANCE 4 (1987), *available at* https://www.jstor.org/stable/253119.

[73] Ronald W. Masulis et al., *Director Liability Protection and the Quality of Outside Directors*, European Corporate Governance Institute – Finance Working Paper No. 672 (2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3329220.

liability restrictions can reduce opportunities and incentives for managers to pursue innovative strategies.[74]

c. The CBA fails to identify and quantify the potential costs of the proposed prohibition on the pass-through of certain fees and expenses.

The CBA fails to analyze whether the purported investor cost savings from the prohibition of the pass-through of fees and expenses associated with regulatory investigations etc. will be outweighed by increases in other fees, including generic management fees, that fund managers may raise in lieu thereof. The CBA acknowledges the possibility of such fee increases but fails to consider whether they are likely to outweigh the purported benefits of the restriction. In fact, there is empirical evidence substantiating the risk that the purported benefits will indeed be outweighed, including evidence indicating that by essentially prohibiting a more detailed itemization of the fees and expenses charged to investors, parties will be forced to aggregate more expenses in generic "catch-all" categories, which will in turn result in more opacity for fund investors. The CBA does not consider this evidence.

The CBA appears to acknowledge at a general level that the prohibition on the pass-through of a specific type of fee many incent a repackaging/renaming of fees and/or the increase in the amount of the general management fee as a means of indirectly redistributing costs.[75] The CBA baselessly suggests that if advisers respond to the prohibition on the pass-through of certain fees by increasing other fees, any such replacement fee would be "more transparent to the investor."[76] However, such a scenario would in fact result in less transparency, as the adviser is compelled to aggregate fees for various categories of expenses into a single charge, such that the investor does not know the extent to which the aggregate fee is attributable to any single constituent expense. Specifically, it may well be unclear to the investor the extent to which a management fee is attributable to compensating the manager for the risk of the potential costs of a regulatory investigation. A significant body of empirical evidence suggests, both with respect to the private fund industry specifically and financial services markets more generally, that it is precisely the disaggregation/itemization or "unbundling" of fees (the reverse of what the Proposed Rule would do) that results in overall cost savings to the recipients of financial services, allowing the recipient to review more precise information about the expenses to which its overall fee expense is attributable.

For example, Monk and Sharma (2015) conclude specifically that fee transparency in private fund agreements - i.e., explicit transparency on the type and amount of fees borne economically by

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[74] Yuyan Guan et al., *Managerial Liability and Corporate Innovation: Evidence from a Legal Shock* JOURNAL OF CORPORATE FINANCE (forthcoming), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3070160 (finding that the introduction of greater statutory limitations on D&O liability under Nevada law resulted in an increase in innovation outputs from Nevada-incorporated firms relative to matched control firms in other states that did not afford such protections, particularly firms facing higher litigation risk or operating in more innovative industries).

[75] *See* Proposing Release at 16,943.

[76] *Id.* at 16948.

investors (whether directly or indirectly), is critical to maximizing investor value.[77] Jackson et al. (2020) found that the unbundling of sell-side research charges from brokerage commissions under MiFID II improved European market efficiency by eliminating redundancy and producing higher-value information for investors, with the result that the cost of sell-side research services were reduced significantly.[78] Monk et al. (2015) similarly found that the unbundling of fees for financial services, such as the separation of payment for third-party research services from commissions for trade execution, increased transparency, and alignment of investors' interests with those of their intermediaries, including external asset managers.[79] Other studies find more generally that pricing complexity in the form of indirect fees harms the recipients of financial services: Carlin (2009) found that price complexity, including in the form of indirect surcharges, may lead to higher costs for financial services.[80] Gabaix (2006) found that indirect fees for financial services can facilitate price discrimination.[81] The CBA does not consider any of these studies.

The CBA also fails to provide evidence that private fund fees are the product of a systematic failure of the private bargaining process.[82] Indeed, reports referenced in the CBA conclude that the relevant measurement to an investor is the net performance of the fund, not the amount of fees, and that private funds have outperformed several major benchmarks as well as their publicly offered counterparts on a net basis. But the CBA ignores these relevant conclusions in the reports that they otherwise reference, and the CBA ignores the considerable empirical evidence that private funds provide substantial diversification benefits and improved risk adjusted returns even after taking fees into account.

For example, Robinson (2012) analyzed the performance of 837 private equity funds over 26 years and found no evidence that higher fees were associated with lower net-of-fee performance. On the contrary, the authors find that private equity managers earned back the fees they charged investors

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[77] Ashby Monk & Rajiv Sharma, *Re-Intermediating Investment Management* (2015), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2625303.

[78] Howell E. Jackson & Jeffery Zhang, *The Economics of Soft Dollars: A Review of the Literature and New Evidence from the Implementation of MiFID II* (2022), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3673470.

[79] Ashby Monk et al., *Transparent Alignment in Investment Research: From Unbundling to Relational Contracting* (2018), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3209952.

[80] Bruce I. Carlin, *Strategic Complexity in Retail Financial Markets* (2006), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=949349.

[81] Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, QUARTERLY JOURNAL OF ECONOMICS (2006), *available at* https://pages.stern nyu.edu/~xgabaix/papers/shrouded.pdf.

[82] At Notes 232 and 334 the Proposed Rule quotes Eli Hoffman, *Welcome To Hedge Funds' Stunning Pass-Through Fees* SEEKING ALPHA (Jan. 24, 2017), *available at* https://seekingalpha.com/article/4038915-welcome-to-hedge-funds-stunning-pass-through-fees for anecdotal evidence of the extent of private fund fees. However, the article goes on to note that several major hedge funds "have produced double digit net returns over the long-term" and that "[l]ow fees are an important piece of the investor toolbox. But investors are also willing to pay for an edge, and judging performance over a one-year timeframe is probably a bad idea."

through higher gross performance.[83] Getmansky et al. (2015) conducted a comprehensive review and synthesis of the empirical research on the performance of hedge funds and their role in the financial system, finding that the hedge fund industry is characterized by rapid innovation and attribution, has offered investors attractive returns net-of-fees, and can serve as an invaluable monitoring system for identifying trouble spots throughout the financial system.[84]

The CBA notes that when charges "are in connection with an investigation of an adviser, it may not be in the fund's best interest to bear the cost of an investigation."[85] However, this is not an accurate framing of the "costs" to which investors are subject in the private fund market as it currently exists. *Ex post* (i.e., after a cost has arisen) it is clearly not in the fund investors' best interest to bear *any* cost, but this is not a realistic outcome in an arm's-length bargaining process. The question is whether it is in the fund investors' best interest to agree to bear such costs or some portion thereof *ex ante*, when the fund documents are being negotiated. The frequency with which highly sophisticated and well-advised investors agree to bear some portion of these risks suggests strongly that they commonly believe that it is in their best interests to do so. As noted above, and as the Proposed Rule acknowledges, private fund investors are typically large institutions and high net worth individuals, represented by elite law firms. This calls into question the benefits that the CBA asserts will arise in the form of reduced costs being imposed on investors, since these investors have evidently made a judgment that by agreeing to bear some portion of certain risks, they have gained advantages (e.g., better terms in other portions of the fund documents; access to scarce investment opportunities offered by some fund managers) that compensated them for those risks.

The CBA also fails to consider how prohibiting the pass-through of compliance-related fees and expenses may adversely restrict funds' investment strategies. A fund's management fee is typically set as a fixed percentage of fund assets.[86] If advisers and investors are effectively required to include an estimate of future compliance costs within the management fee *ex ante*, rather than separately accounting for such costs when incurred, advisers will be incentivized to minimize compliance costs, thus resulting in less being spent on compliance. Because investing in a greater number of portfolio companies in a greater variety of industries and engaging in hedging activities

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[83] Robinson, *supra* note 63.

[84] Mila Getmansky et al., *Hedge Funds: A Dynamic Industry in Transition*, National Bureau of Economic Research Working Paper 21449 (2015), *available at* https://www nber.org/system/files/working_papers/w21449/w21449.pdf; *see also* Bing Liang, *On the Performance of Hedge Funds* (1998), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=89490 (finding that average hedge fund returns are related positively to incentive fees and that hedge funds exhibit low correlations among different strategies and low systematic risk); Stephen J. Brown et al., *Hedge Funds and the Asian Currency Crisis of 1997*, National Bureau of Economic Research Working Paper 6427 (1998), https://www.nber.org/papers/w6427 (rejecting the hypothesis that hedge funds were responsible for the 1997 Asian currency crisis); Thomas Schneeweis & Richard Spurgin, *Quantitative Analysis of Hedge Fund and Managed Futures Return and Risk Characteristics* (1997), *available at* https://www.semanticscholar.org/paper/1-Quantitative-Analysis-of-Hedge-Fund-and-Managed-Schneeweis-Spurgin/ee20b8a6323c7d1c7625e37570d61ab18e0f23db?p2df; Brown (1999), Liang (1999)

[85] Proposing Release at 16,948.

[86] *See* Robinson, *supra* note 63 at 2.

all potentially increase the adviser's compliance expenses[87], advisers may cause funds to hold less diversified portfolios by investing in fewer companies in a more limited range of industries, and to hedge less. Such restrictions may reduce private fund performance and result in private funds investing in riskier, less diversified portfolios.

d. The CBA fails to identify and quantify the costs of the proposed prohibition of net-of-tax clawbacks.

The prohibition on net-of-tax clawbacks is based on an inaccurate understanding of the taxation of funds, fund investors and fund advisers, and the methods by which such parties allocate tax liabilities as part of arm's-length bargaining process. The CBA, which is based on this inaccurate understanding, therefore fails either to identify or quantify the risks attendant to this prohibition.

The CBA refers to the reduction of clawbacks for taxes as an "avoidable cost," suggesting that the taxes imposed on a GP's carried interest could be avoided.[88] However, because private investment funds are commonly treated as partnerships for U.S. federal income tax purposes, fund managers are taxable on their allocable share of income from the fund, so these taxes are not avoidable.

The CBA suggests that one of the intended benefits of the prohibition on net-of-tax clawbacks is to ensure that investors receive "their full share of fund profits."[89] However, the CBA does not offer a definition of what constitutes a "full share" of such profits. Investors and advisers commonly agree to share profits and expenses in amounts and percentages that are not proportionate to their capital contributions. The CBA offers no evidence for the view that net-of-tax clawback are uniquely harmful to investors in comparison to other terms that allocate profits and losses as between investors and the fund adviser. The CBA also does not consider whether the forced reallocation of costs that would be necessitated by its prohibition is likely to instigate renegotiation of other fund terms that may leave fund investors worse off. For example, private fund advisers may seek to negotiate fund agreements that lack clawbacks altogether, or seek to reduce the amount of clawbacks by fixed percentages intended to estimate the effect of taxes. The benefits of clawback provisions as means to enhancing investor value are substantiated in the empirical literature (see Liu et. al (2019) and Chen et al. (2012)).[90] A prohibition that makes

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[87] *See, e.g.*, Norton Rose Fulbright, *Private equity funds and co-investment: A symbiotic relationship* https://www nortonrosefulbright.com/en/knowledge/publications/12c81c8a/private-equity-funds-and-co-investment (noting the potential for greater legal compliance expenses when investing in portfolio companies in multiple jurisdictions); Kevin Jones, The True Cost of Hedging CHATHAM FINANCIAL https://www.chathamfinancial.com/insights/the-true-cost-of-hedging (noting the significance of legal and regulatory compliance costs associated with hedging activities).

[88] Proposing Release at 16,937.

[89] *Id*. at 16,924.

[90] Hanni Liu et al., *The Impact of Clawback Adoption on Executive Cash Compensation Structure*, 2019 Canadian Academic Accounting Association Annual Conference (2019), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3315571 (finding that clawbacks reduce asymmetry between firm performance and manager compensation); Mark A. Chen et al., *The Costs and Benefits of Clawback Provisions in CEO Compensation*, REVIEW OF CORPORATE FINANCE STUDIES (2012), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1980406 (finding that clawbacks curb misreporting of firm performance and are associated with a stronger relationship between manager performance and compensation).

clawbacks more costly and inefficient thus has the potential to harm investors. These are costs which the CBA also fails to consider.

e. The CBA fails to substantiate the purported benefits of required quarterly statements and fails to identify and quantify the likely costs.

The proposed quarterly statements, while already commonplace among large private fund advisers, would place disproportionate burdens on smaller fund complexes and potentially introduce competitive distortions into the market. However, the CBA does not justify these burdens with the putative benefits of the Proposed Rule, stating that it is "generally difficult to quantify these economic effects with meaningful precision."[91]

The CBA thus fails to substantiate the benefits of the proposed disclosure requirement and to consider the full extent of its potential costs. Instead, the CBA's analysis of the purported benefits and costs of the disclosure requirement is so general that it could apply to *any* disclosure proposal on any subject whatsoever, in that the "costs" are deemed to include the direct costs of compliance on the part of the private fund adviser, and the "benefits" are the increased transparency and ease of "monitoring" for the subject matter in question. The CBA acknowledges that, where not otherwise prohibited, the increased costs associated with the quarterly statements are likely to be passed on by private fund advisers to the funds and ultimately to investors,[92] but does not address the *balance* of costs and benefits to investors, as discussed below.

The CBA fails to clarify the nature of the benefits that it expects to flow from increased disclosure or to quantify those benefits. The CBA suggests that limitations on investors' ability to obtain additional disclosure of fund terms and disparities between information provided to different investors can prevent even sophisticated investors from "optimally obtaining certain terms of agreement from fund advisers" and that this can result in investors "paying excess costs, bearing excess risk, receiving limited and less reliable information about investments, and receiving contractual terms that may reduce their returns relative to what they would obtain otherwise."[93] While it is clear that fund documents commonly allocate certain costs and risks to investors, it is unclear what alternative scenario the proposed disclosure requirements would help to attain. In particular, the CBA does not quantify the benefits to investor returns that it expects additional disclosure to produce or clarify what it means for an investor to "optimally obtain" a particular term or how additional disclosure would enable investors to achieve such terms. These are factors that can only be determined by an arm's-length bargaining process in the context of prevailing market conditions – a process which has consistently produced bargained-for terms that the proposed rule now intends to prohibit.

Moreover, the CBA notes that its proposal is based on an observation that "investors lack sufficiently detailed information about fund fees and expenses and the preferred terms granted to certain investors and often lack sufficient transparency into how private fund performance is calculated." The CBA however does not explain how it arrived at this conclusion concerning the

[91] Proposing Release at 16,944.

[92] *Id*. at 16,946.

[93] *Id*. at 16,943.

private funds market generally or quantify the amount or value of information that investors purportedly lack. Nor does the CBA acknowledge that different classes of investors may have differing informational demands such that a one-size-fits all approach could result in significant inefficiencies by requiring managers to make disclosures to investors that do not demand the disclosed information while failing to address the particularized disclosure needs of individual investors.[94]

The Proposed Rule asserts that requiring fund advisers to report "each category of fee or expense" to their investors will enable investors to compare funds more easily.[95] However, by requiring advisers to report separate line items for "each category of fee or expense" without providing a comprehensive list of relevant line items, the Proposed Rule will require fund advisers to apply subjective interpretations as to how separate fees and expenses are categorized, potentially resulting in less standardized disclosures than those currently provided to investors. To the extent the SEC remains committed to requiring fund advisers to provide standardized disclosures to their investors, the Committee respectfully suggests that such disclosures be in the form of GAAP audited financials.

The CBA also fails to take account of the full extent of the likely costs associated with its disclosure requirements. Specifically, the CBA at one point suggests that the cost to fund managers of the fee and expense reporting requirements would be "limited to the costs of compiling, preparing and distributing the information for use by the investors and the cost of distributing the information to investors."[96] There could be other costs though beyond simply complying with the administrative aspects of the rule, including that by increasing the minimum amount of disclosure that fund managers are required to provide all investors, it is inhibiting fund creation by smaller managers, which will face higher operating costs.

Moreover, the CBA fails to consider the operational burden imposed by the frequency and timing of the required reports. By requiring reports to be prepared quarterly and within 45 days of the quarter end[97] the Proposed Rule's disclosure requirement is more onerous than those that apply to publicly offered regulated investment companies.[98] Requiring reports to be prepared four times per year and 45 days after the close of the quarter end will create a significant and ongoing operational burden for fund advisers. To the extent that the SEC remains committed to requiring fund advisers to provide additional disclosure to fund investors the Committee respectfully suggests that such disclosure be no more frequent than semi-annual and issued no sooner than 60

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[94] *See, e.g.*, De Fontenay, *supra* note 6 (finding that a very significant portion of side letter provisions regarding fund disclosures are focused on addressing investors' particular informational needs (e.g., regulatory or tax compliance burdens)).

[95] Proposing Release at 16,891.

[96] *Id*. at 16,945.

[97] *Id.* at 16,944.

[98] Such funds are required to provide semi-annual shareholder reports within 60 days after the end of each reporting period. 15 U.S.C. 80a-29(e).

days after the end of the relevant reporting period, in line with the requirements applicable to public investment funds.

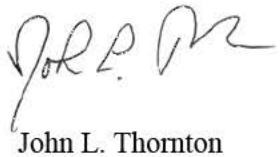
3. CONCLUSION

The Committee respectfully submits that the SEC should reconsider its authorities to regulate in this area in the context of both its cited statutory authority as well as the general public/private structure of U.S. securities markets. These sweeping proposals represent a significant departure from the understanding of the private fund market that has prevailed for decades, and the proposing release and cost-benefit analysis do not provide a sufficiently reasoned foundation in statutory law or public policy to warrant the suggested reforms.

* * *

Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott [redacted], or its Executive Director, John Gulliver [redacted], at your convenience.

Respectfully submitted,



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