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

Submitted via email to rule-comments@sec.gov

Re: File No. S7-03-22

Dear Ms. Countryman:

This comment letter is being provide regarding the private fund rule proposal, "Private Fund Advisers; Documentation of Registered Investment Compliance Reviews." (the "Proposal"). Baird Capital, a division of Robert W. Baird & Co. Incorporated, makes venture capital, growth equity and private equity investments in strategically targeted sectors globally. Since 1989, Baird Capital has raised and managed more than $3.9 billion and invested in over 330 portfolio companies. Baird Capital sponsors venture capital and global private equity funds managed by affiliated investment advisers registered with the U.S. Securities and Exchange Commission (the "SEC") for an investor base comprised of institutions, high net worth individuals and employees.

The Proposal encompasses significant changes to the rules regulating private funds. We have studied how the Proposal would impact Baird Capital, our investors, and private fund advisers more generally and believe certain aspects of the Proposal are problematic and will have a negative impact on one or more of these stakeholders. We recommend that each of the provisions discussed below be removed from the Proposal before it becomes a final rule.

The specific parts of the Proposal that we believe are problematic include:

1) The proposal to prohibit private fund advisers from reducing the amount of clawback amounts by applicable taxes.[1]
2) The proposal to limit private fund advisers' ability to seek reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors in providing services to the private fund.[2]
3) The proposal to prescribe quarterly statement calculations for illiquid funds exclude fund-level subscription facilities.[3]

We have addressed each of these problematic elements of the Proposal in detail below.

<u>Clawback of Taxes Payable by the Adviser</u>

The Proposal would prohibit the general partner ("GP") of a private fund from reducing the amount of performance-related fees subject to clawback (i.e., returned to the fund) by the amount of distributions made to the GP to cover the estimated taxes its members owed on taxable gains allocated to it throughout the life of the fund ("Carry Tax Payments").

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[1] Proposed rule: § 275.211(h)(2)-1 Private fund adviser prohibited activities. Subsection-(a)(4).
[2] Proposed rule: § 275.211(h)(2)-1 Private fund adviser prohibited activities. Subsection-(a)(5).
[3] Proposed rule: § 275. 211(h)(1)-2 Private fund quarterly statements. Subsection-(e)(2)(ii)(A).

As discussed below, we believe forcing the GP to return Carry Tax Payments is inappropriate given the risk that it could cause economic hardship to members of the GP. Because tax carry payments are necessary due to income allocations to the GP mandated by section 704(b) of the tax code, **we contend a better answer is for the SEC to work with the U.S. Internal Revenue Service to revise the tax code to cause the GP to be taxed based on the actual cash flows in accordance with the distribution waterfalls of the respective fund limited partnership agreements**. Doing so would eliminate the tax burden suffered by the GP due to section 704(b) of the tax code.

The limitation on clawbacks is common in private fund limited partnership agreements and is widely accepted by investors, including sophisticated institutional investors that negotiate the terms of such agreements. Introducing this prohibition is a significant change that will have uncertain impacts and will be disruptive to an existing and long-standing practice that, we believe, is equitable and reasonable to both GP and investors in that it is premised on an understanding that the GP should only be required to return amounts that it actually retains.

Inherent in the SEC's proposal to overrule the agreed upon terms of these limited partnership agreements and force the GP to claw back carry tax distributions is the assumption that this can be done with no harm to the parties involved. This assumption is flawed because it assumes that all members of the GP are able to utilize the tax loss created by such clawbacks – which may not be the case. In fact, because clawback payment-related tax losses are typically subject to significant limitations, including in many cases a prohibition on carrying back such tax losses, the proposed rule creates a real risk that in certain cases some members of the GP would be in a worse after-tax position than if no performance-based compensation had been charged.

In January 2011, the Institutional Limited Partners Association ("ILPA") issued *Private Equity Principals Version 2.0*. Among the issues addressed in this publication, ILPA addressed carry clawback best practices. With respect to the GP carry tax burden, ILPA concluded (<u>underlining added for emphasis</u>):

> "GPs receive tax distributions from the fund in order to pay their tax liabilities on carry (capital gains tax treatment). To the extent that the GP either does not receive (or must return) carry, there is a loss of the tax paid <u>since there are limitations on the GP's ability to carry back losses to offset the gains on which tax was previously paid</u>. Historically, LPs have absorbed this loss on behalf of GPs. The initial release of Principles stated that all carry clawbacks should be gross of tax, but after extensive discussions with GPs, <u>we believe that it would be impractical to ask them to bear the cost</u>."

Amending a funds' tax returns may also be disruptive to investors whose previously filed tax returns could be affected by such amendment. This assumes the fund has the ability to elect out of the Bipartisan Budget Act ("BBA") of 2015 and has the ability to amend prior year tax returns. Most funds are ineligible to elect out of BBA and would be unable to amend. These funds would be required to file an administrative adjustment request (AAR) which would cause an administrative burden not only to LPs but to GPs as well. Furthermore, if the GP clawback is reported as a capital loss in the current year of the clawback, it may result in a character mismatch to the detriment of the GP. So, if the fund files an AAR or reports a capital loss in the current year, these capital losses are subject to limitation during the current tax year. Whether the GP can utilize these capital losses would depend on each individuals' tax circumstances, which is out of the GP control, and mostly likely would cause GP members to be in a worse after-tax position, as stated above. Thus, while the GP may have a certain level of control over allocations and distributions of incentive compensations, as a practical matter, such control may not afford the GP the means of effectively remedying the cost of taxes it already paid with respect to income subject to the clawback.

We anticipate that advisers would seek to implement alternative arrangements to address these legitimate GP concerns. We believe the Proposal if adopted will potentially distort the market in unforeseen ways as advisers seek to establish a new equilibrium that addresses the legitimate concerns of advisers while remaining equitable to investors.

For these reasons we urge the SEC to remove this provision from the Proposal.

Prohibiting Indemnification for Negligence

Under the Proposal, a private fund adviser or its affiliate (including the private fund's general partner) would be prohibited 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.

Prohibiting adviser exculpation and indemnification for ordinary negligence is a significant departure from the industry standard of providing adviser exculpation and indemnification except in instances of gross negligence. We believe this prohibition would have unintended consequences and would negatively impact the private fund industry.

Private fund managers have historically negotiated exculpation and indemnity provisions with sophisticated investors in limited partnership agreements and the terms have become fairly standard and consistent. These negotiations strike a commercially reasonable balance between investor interests and advisers and have received wide-spread acceptance amongst advisers and investors.

The Proposal by adopting this prohibition is moving the private fund industry to a seemingly strict liability standard of care. This presents a higher risk to fund sponsors and could potentially disincentivize new fund manager launches, thereby potentially reducing investors' access to newer and more innovative managers. Furthermore, the proposal may cause fund managers to avoid certain types of riskier investments that may generate outsized returns to private fund investors and are one attraction of private funds in a well-diversified portfolio. Finally, the additional risk this potential liability presents to advisers may result in investors paying higher expenses or fees than they may otherwise have, particularly if litigation, insurance costs or other expenses are incurred by advisers as a result of the Proposal.

For these reasons we urge the SEC not to adopt this provision in the Proposal as we believe it could suppress the dynamic aspects of the private fund industry while potentially raising investor costs.

Fund-Level Subscription Facilities Exclusion in Quarterly Statements

We do not believe that quarterly statement calculations for illiquid funds should be required to exclude fund-level subscription facilities. We believe this change would be difficult to implement consistently without extensive direction from regulators, potentially misleading or confusing to investors, and overly burdensome, particularly to the extent it needs to be applied retroactively.

The Proposal would necessarily require advisers to make assumptions regarding the timing of capital calls that would have been made but for the use of a subscription facility. The Proposal does not address criteria for making this determination on timing and, we believe, may result in inconsistency between firms and potentially manipulation by firms setting such fictitious call dates solely with an eye to maximize reported returns.

Furthermore, this provision of the Proposal will be detrimental to those advisers that use subscription facilities in a skillful manner and that have the banking relationships needed to obtain favorable subscription facilities. This will impact investors because they will be hindered in identifying such advisers.

We believe the use of fund-level subscription facilities is of benefit to investors in that it reduces the frequency of capital calls, positively impacting the investor experience, as well as reducing overall administrative expenses by reducing costs associated with each additional call. We do not believe it is a good idea for the SEC to seek to disincentivize the use of fund-level subscription facilities.

Finally, we do not believe that comparability across private funds should come at the expense of comparability across asset types. The exclusion of subscription facilities will result in calculation of returns that will be fundamentally misleading in that such returns do not reflect the actual return to the investor. We believe that the requirement to exclude fund-level subscription facilities is unfair to private funds because investors will be viewing returns that may be reduced from the actual returns earned by the investor and comparing that to returns from other asset types which have not been impacted by this overly prescriptive Proposal.

For each of the reasons set forth above we believe that fund returns should continue to incorporate fund-level subscription facilities, perhaps with additional disclosure requirements. However, if this provision of the Proposal is eventually required in a final rule, we believe the SEC should provide detailed guidance regarding how to perform such calculations to assure comparability between advisers.

In conclusion, we believe each of the three parts of the Proposal that we have discussed above should be removed or improved before the resultant rules are finalized. Thank you for your consideration of this request.

Sincerely,

/s/ Scott Skie
Chief Operating Officer
Baird Capital, a division of Robert W. Baird & Co. Incorporated