NYSIF
New York State Insurance Fund

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Via email, rule-comments@sec.gov

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

Re: File Number S7-03-22
Comments on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (February 9, 2022)

Dear Ms. Countryman:

The New York State Insurance Fund ("NYSIF") welcomes the opportunity to comment on the Commission's above-referenced proposed rule ("Proposal")[1] to protect investors by promoting transparency and integrity in private funds, including private equity, venture capital, and hedge funds. NYSIF is a not-for-profit, competitive insurance company with a statutory mandate to (1) provide low-cost workers' compensation, disability, and paid family leave coverage, (2) pay timely benefits to claimants, and (3) maintain a solvent insurance fund. NYSIF fulfills these obligations as a fiduciary, in part, by investing its premium income in diverse asset classes to generate a return.[2]

Over the past decade, private funds have experienced explosive growth as institutional investors such as public pension funds, foundations, endowments, and others have invested heavily in them.[3] But as investor demand has soared, private market regulation has failed to keep pace, producing a competitive imbalance favoring fund advisers over investors. This disparity in bargaining power severely disadvantages investors. To gain entry to a fund, investors often must accept one-sided contractual provisions, such as those waiving adviser fiduciary obligations or entitling advisers to fees for unperformed services. Investors also must contend with a lack of consistent and standardized information on fees, expenses, and fund performance, impeding their

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC, 86 Fed. Reg. 16886 (Mar 24, 2022), https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf

[2] To learn more about NYSIF, please visit https://ww3.nysif.com/

[3] Private funds have approximately $18 trillion in assets under management. *See,* Stefania Palma, Eric Platt, and Antoine Gara, *SEC seeks to bolster disclosure rule for private equity and hedge funds*, Financial Times, Feb. 9, 2022, https://www.ft.com/content/ddb097f8-41bd-41c9-916e-713ea4035d8d

ability to evaluate and compare investments across funds or track adviser fees and expenses. An opaque process of negotiating bespoke "side letters" with undisclosed preferential terms for select investors further erodes investor confidence and challenges even the most sophisticated investors.[4]

As the Proposal and various staff reports[5] and agency enforcement actions[6] document, these difficulties can hinder investor decision-making and have led to abusive practices that undermine investor and public trust.[7] The Proposal addresses these challenges by (1) mandating that registered private fund advisers provide quarterly statements to investors with standardized and detailed information regarding fees, expenses, and performance, (2) requiring private fund advisers to obtain an audit by an independent public accountant at least annually and upon liquidation for each fund they advise, (3) prohibiting all private fund advisers from engaging in certain activities that are "contrary to the public interest and the protection of investors," including seeking a waiver for a breach of fiduciary duty and similar legal standards as well as charging certain fees; and (4) prohibiting all private fund advisers from providing preferential terms to certain investors regarding redemption and information about portfolio holdings and exposures.

NYSIF supports these measures, as detailed below.

Quarterly Statements and Audits: Improving Transparency and Accountability

To make sound investment decisions, investors need access to information. While some advisers provide periodic statements on fees, expenses, and fund performance, there is no requirement to do so.[8] Where advisers furnish periodic reports, information may not be sufficiently detailed or standardized.[9] These factors make fund performance comparisons and fee and expense tracking challenging. The Proposal's requirement for advisers to provide quarterly statements in a standardized format will deliver investors crucial information, enabling them to gauge adviser track records and appropriateness of costs. The information will help investors decide whether to invest or remain in a fund, empowering greater choice and fostering competition.

Equally as important as mandating quarterly statements is ensuring the information's integrity and accuracy. As Commission staff has documented, adviser disclosures have sometimes

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[4] *See e.g.*, Juliane Begenau and Emil Siriwardane, How Do Private Equity Fees Vary Across Pensions? Harvard Business School Working Paper, No. 20-073, Jan. 2020 (Rev. March 2022), https://www.hbs.edu/faculty/Pages/item.aspx?num=57534

[5] *See, e.g.,* Observations from Examinations of Private Fund Advisers, Division on Examinations, SEC, Jan. 27, 2022, https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf

[6] *See, e.g., In re Kohlberg, Kravis, Roberts & Co. L.P.*, Investment Advisers Act Release No. 4131 (June 29, 2015); *In re Blackstone Management Partners LLC et al.*, Investment Advisers Act Release No. 4219 (Oct.7, 2015).

[7] Chris Flood, *Investors take aim at private equity's use of private jets*, Financial Times, November 8, 2021, https://www.ft.com/content/1212b266-8760-4766-a03e-9e7db203b5d2

[8] Proposal, at 16890.

[9] *Id.*

been incomplete, inaccurate, and misleading.[10] The Proposal's requirement for independent fund audits to be conducted at least annually will ensure that investors have confidence in the information provided in quarterly reports, including the adviser's criteria, assumptions, and methodologies to measure fund performance and valuation. Quarterly statements and regular independent audits will increase transparency and help investors make prudent investment decisions. We encourage the Commission to consider requiring investor-specific information where plausible and ensure robust audits.

Prohibiting Waiver of Fiduciary Duty and Certain Activities

The effect of uneven bargaining power is apparent in certain private investment contract terms. For example, investment contracts often require investment funds (and, by extension, investors) to waive the fiduciary duty owed by the fund adviser. The fiduciary duty waiver may be explicit, such as by indemnification, exculpation, or limitation,[11] or by inserting a substitute standard of care – specifically, vesting the adviser with "sole and complete discretion" to discharge its contractual duties. Such provisions have been criticized by the Commission[12] and appear to be contrary to the concept of fiduciary duty, which requires fully placing the client's interests (here, the fund) ahead of the adviser's interests.

If the fiduciary is not responsible for a breach, the client bears the cost, raising "moral hazard" risk. As the Commission observed, "[b]y limiting an adviser's responsibility for breaching the standard of conduct, the incentive to comply with the required standard of conduct is eroded."[13] The Proposal prohibits private fund advisers from seeking indemnification or exculpation for breach of fiduciary duty,[14] restoring meaning to the foundational concept. We caution, however, that since fund contracts often vest authority in advisers' own lawyers or accountants to resolve potential misconduct claims, this prohibition may not be enough. Presumably, there can be no breach of fiduciary duty if the lawyer or accountant says otherwise. The Commission should consider banning such provisions as against public policy.

NYSIF also supports the Proposal's prohibition on certain fees. These include fees for unperformed services, such as accelerated monitoring fees; fees or expenses associated with an investigation or regulatory examination; regulatory or compliance expenses; and fees and expenses related to a portfolio investment on a pro-rata basis when multiple private funds and other clients have invested in the same investment.[15] The Commission's enforcement actions detail abuses arising from such provisions and prohibiting them will ensure that unsubstantiated or unwarranted

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[10] Supra, note 5.

[11] Proposal, at 16920.

[12] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)], at 33671, https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf

[13] Proposal, at 16925.

[14] Proposal, at 16920.

[15] *Id.*

fees do not dilute investor returns, reducing incentives for advisers to place their own interests ahead of their clients.

Preferential Terms

Private fund advisers often negotiate "side letters" that grant certain investors terms more favorable than those set forth in the fund's governing documents. As the Commission observes, side letters are granted for "strategic reasons that benefit the adviser," "do not necessarily benefit the fund or other investors," and, "can have a material, negative effect on other investors."[16] The Proposal would prohibit all private fund advisers from providing preferential terms to certain investors regarding fund redemptions or information about portfolio holdings or exposures.[17] The Proposal also would prohibit advisers from giving any other preferential terms without written disclosures to prospective and current investors.

NYSIF supports these provisions. First, as the Commission has observed, an adviser may grant favorable redemption rights, for example, in exchange for "a large investor agreeing to invest in the funds or a large investor agreeing to participate in a future fundraising of an investment vehicle the adviser manages."[18] Since adviser fees increase as funds under management grow, this would undoubtedly benefit the adviser. But it could also be detrimental to the remaining investors if the adviser sells liquid assets to accommodate the preferred investor's redemption, inhibiting the fund's ability to satisfy other redemption requests promptly.

Second, selective disclosures of portfolio holdings or exposures can lead to an unlevel playing field between investors, some of whom would be able to profit or avoid losses based on information not equally available to all investors. An adviser could exchange increased transparency for something of benefit to the adviser, further misaligning incentives and distorting markets. Finally, increased transparency regarding all preferential terms in a fund would inform investors better, helping them negotiate their own terms more effectively with an adviser. This measure would go far in helping restore a level playing field between advisers and investors and promote market efficiency.

Conclusion

Critics might argue that institutional investors are sophisticated and do not need the protections afforded by the Proposal. As they see it, investors are free to negotiate an investment contract to their satisfaction or find another manager who will give them better terms. They could also refrain from investing in the asset class if they choose.

But these arguments are unpersuasive. As noted above, private fund markets suffer from uneven bargaining power and informational asymmetry that harm investors. Furthermore, institutional investors are already heavily invested in private funds and are likely to increase

[16] Proposal, at 16928.

[17] *Id.*

[18] Proposal, at 16929.

allocations given economic and market dynamics.[19] A hands-off approach will further distort markets, while the Proposal will foster sustainable economic growth.

As the Commission moves to implement these reforms, we recommend it do so in a manner that considers regulatory burdens on smaller, emerging managers, many of whom are minority and women-owned businesses and who are vital to restoring a sense of balance and promoting competition among private funds.

The Proposal takes an essential step to level the playing field between investors and advisers, increasing transparency and restoring trust in private fund markets. If adopted, it will spur competition, promote market efficiency, and help institutional investors like NYSIF meet their fiduciary obligations.

We urge the Commission to finalize the Proposal without delay.

Sincerely,

Gaurav Vasisht
Executive Director and Chief Executive Officer

cc: Honorable Gary Gensler, Chair
Honorable Hester M. Peirce, Commissioner
Honorable Allison Herren Lee, Commissioner
Honorable Caroline A. Crenshaw, Commissioner
William Birdthistle, Director, Division of Investment Management

[19] Akila Quinio, Investors rush into private markets in search of returns, Financial Times, Nov. 29, 2021. https://www.ft.com/content/97bb96b5-87c7-4734-a4dc-c72d33e297ac