STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

THOMAS P. DINAPOLI
STATE COMPTROLLER

Pension Investment and Cash Management
59 Maiden Lane–30th Floor
New York, NY 10038

April 25, 2022

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

Submitted via email to rule-comments@sec.gov

Re: File Number S7-03-22; Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

Dear Ms. Countryman:

On behalf of the Comptroller of the State of New York (the "Comptroller"), as Trustee of the Common Retirement Fund (the "CRF"), we submit this letter in response to the request of the Securities and Exchange Commission (the "SEC") for comment in connection with the SEC's proposed rules under the Investment Advisers Act of 1940 regarding private fund advisers (Release Nos. IA-5955, File No. S7-03-22).

The CRF holds and invests the assets of the New York State and Local Retirement System. With an estimated value of $279.7 billion as of December 31, 2021, the CRF is one of the largest public pension plans in the United States, providing retirement security for over one million members, retirees and beneficiaries.

The CRF is a long-term institutional investor with a diversified portfolio in which private investment funds play an important role. The CRF began investing in private equity in 1983 and as of its fiscal year ended March 31, 2021, the total fair value of its investments in the following asset classes was over $64 billion: private equity, real estate, real assets, credit, and opportunistic/ARS. Those investments are primarily through private investment funds, including both open-end and closed-end funds, large commingled funds, captive funds ("funds-of-one") as well as investments in smaller, niche funds managed by smaller private fund advisers, funds organized and managed in the U.S. and funds organized and managed outside of the U.S., and as

of March 31, 2021, held investments in 532 funds.[1] The CRF therefore has deep familiarity with issues raised by the SEC and commends the Commission for these important proposals addressing matters New York State Comptroller DiNapoli has long championed. We are pleased to submit these comments.

As we are generally very supportive of the proposed rules, for purposes of brevity, we will focus our comments on particular concerns and suggestions we have rather than detailing every instance where we agree with the proposed rules.

General Comments

We would like to start with two over-arching observations to frame our comments. First, other than a differentiation in the performance metrics required in the quarterly statement rule for liquid and illiquid funds, the proposed rules apply equally to both open-end and closed-end funds; however, we believe that many of the concerns that the SEC is trying to address are much more prevalent in (or even exclusive to) open-end funds. This is particularly true in the proposed preferential treatment rule, where the SEC is aiming to stop advisers from granting preferential liquidity terms to an investor to the detriment of other investors; however, by and large, advisers only grant liquidity terms to investors in open-end funds. We encourage the SEC to consider whether certain rules would be more suited to apply only to open-end funds. This would avoid any unintended consequences in the closed-end fund space.

Second, the structure of private investment funds and the negotiations for an investor's subscription consolidates power and leverage with the fund adviser. Each investor negotiates the private fund terms on a separate basis with the fund adviser, thereby diluting the leverage of each individual investor. As a result, each investor, regardless of size, has less information about the negotiations than the fund adviser. Those factors combined with each individual investor's internal diversification requirements and objectives and underwriting standards generally leaves investors in a disadvantaged state relative to the fund sponsor, particularly with respect to the funds of high-performing managers where the investor demand exceeds the amount of capital that a particular fund can accommodate.

In our experience, as a result of this dynamic, fund sponsors are in a position to discourage negotiations and often attempt to avoid any meaningful engagement. Playing on investors' concern of losing a potential allocation, investors are pushed to be term-takers. Anecdotally, we have heard from some smaller investors that they often do not push to improve overall fund terms and instead hope that larger investors will make the comments and negotiate better terms for the fund because they fear if they make too many comments, the advisers will revoke their allocation.

While a large institutional investor may have more negotiating leverage compared to a small investor, even a large investor cannot unilaterally dictate terms, and neither type of investor has as much leverage in the negotiation when compared to the adviser. A frequent refrain that the CRF receives in response to its request for improved fund terms that would benefit all investors is: "respectfully declined."

[1] https://www.osc.state.ny.us/retirement/resources/2021-nyslrs-comprehensive-annual-financial-report

Quarterly Statement Rule (Proposed Rule 211(h)(1))

The CRF applauds the SEC on its proposal for fund-level quarterly reporting on fees, expenses, and adviser compensation and performance. Disclosure to investors on fees and expenses is an industry reform that Comptroller DiNapoli has advocated for many years. Such information will enable investors to more accurately compare funds while conducting due diligence and will also enable them to more readily assess whether advisers are complying with the terms of their contracts. To facilitate the comparability of this information, we believe the SEC should establish a template for the fund-level information called for by the rule. While some advisers may protest that a template approach is too rigid and does not fit the circumstances for every fund, this concern could be alleviated with different templates for different types of funds. Moreover, as we have found with the Institutional Limited Partners Association (ILPA) fee reporting template, another solution is to allow advisers to leave parts of the template blank to the extent they do not apply to a particular fund.

While supportive of this fund level disclosure, we are concerned that managers will provide this fund-level information *in lieu* of investor specific information. The CRF requires the ILPA template for its private-equity funds and the template provides information similar to that covered by the quarterly statement rule; however, the information reported on the ILPA template is investor-level information. Over the last six years since its introduction, more and more advisers, particularly larger advisers, have adopted the template.

The CRF has found that, overall, the ILPA template has been a good approach and provides CRF with investor-level information. The quarterly statement rule addresses various categories and details which are not included in the ILPA template and so the quarterly statement rule would provide additional information for each investor's internal decision-making and monitoring. We propose therefore that the SEC require advisers to continue to provide investors with personalized (*i.e.*, investor-level) information at their request in addition to the fund level information in the quarterly reporting rule. While we believe that some managers may complain about a compliance burden, this approach provides a needed incentive for advisers to coalesce around best-practice disclosures and greater standardization, which would likely minimize the amount of customization that particular investors might need to seek.

Finally, in response to the SEC's question regarding whether the SEC should "require advisers to disclose their anticipated management fee revenue and operating budget to private fund investors or an advisory committee (LPAC) or other similar body on an annual or more frequent basis." We think disclosure of anticipated management fees and operating budget would be a helpful disclosure to investors while conducting their due diligence, with subsequent annual disclosure of prospective budgets, along with actuals from the prior year. Disclosure to all investors is preferable to disclosure to an LPAC, since an advisory committee should not be expected to have an oversight role over the adviser.

Prohibited Activities: Limiting or Eliminating Liability for Adviser Misconduct (Proposed Rule 211(h)(2)-1, clause (5))

The CRF readily supports the SEC's proposed rule prohibiting advisers from seeking indemnification or exculpation from 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. The CRF looks for and attempts to negotiate protections like these in its private fund investments, unfortunately, without uniform success. We agree with the SEC that this rule is necessary as disclosure and negotiation have not in and of themselves proven to be able to protect investors in all circumstances. Further, this proposed rule speaks to a fundamental component of the private fund, adviser and investor relationship—that the adviser should be a fiduciary and not place its own interests ahead of the fund or the investors. Waivers thereof should be invalid.

The CRF would suggest adding "violation of securities laws" to the list of prohibited grounds for indemnification and exculpation. A violation of securities laws by an adviser should be an automatic disqualification from indemnification and exculpation, without the need for investors to prove any other grounds for disqualification. This is another issue that the CRF typically pushes for in negotiation but does not always receive.

Advisers should also not be allowed to require a private fund or its investors to fund indemnification for, or allow for exculpation of, material breaches of an investor's side letter.

We would also note that there are other common contractual provisions in private fund documents that are related to fiduciary duties, conflicts and waivers, which the SEC should consider prohibiting.

First, we have seen an increase in advisers requesting broad waivers or consents regarding conflicts of interests. Private placement memorandums have always included disclosures regarding conflicts of interest. We have noticed that these disclosures have increased in recent years, often by advisers disclosing everything and anything that could possibly be a conflict of interest without any focus on actual conflicts (or even expected conflicts). This kitchen-sink approach becomes overwhelming and the disclosures often end up being meaningless. While we generally do not appreciate this approach from advisers, at the end of the day, the memorandum is a disclosure document and not an operative contract. The problem from advisers that we have seen more recently is that the limited partnership agreement will incorporate the memorandum by reference or the subscription agreement will include a waiver by the investor of the risks and conflicts disclosed in the memorandum. This type of provision—in the operative documents—is tantamount to a full waiver of conflicts and fiduciary duties which should not be allowed.

Secondly, limited partnership agreements typically include an interpretative provision that if the general partner (or adviser) is permitted under the limited partnership agreement to make a determination in its "discretion" or "sole discretion" that such party may consider any interests it chooses, including its own interests and has no obligation to consider the interests of the private fund or its investors. Provisions like these can be used by an adviser to justify putting its own interests ahead of the fund or the investors (or in the least, give the impression that advisers are

allowed to do that). Provisions like these should be prohibited, or only allowed to the extent that the adviser is not allowed to put its own interests ahead of the fund or otherwise disadvantage the fund.

Prohibited Activities: Non-Pro Rata Fee and Expense Allocations (Proposed Rule 211(h)(2)-1, clause (6))

The CRF is generally supportive of the SEC's proposed rule regarding pro rata treatment among investors; however, as the CRF regularly employs funds of one and separately managed customized funds to address or fill particular portfolio needs, we request that the Commission consider the implications of this rule on investors' ability to invest in funds and products that are more closely aligned with their specific investment requirements or targets.

Additionally, the CRF requests that the SEC take another look at the proposed treatment of "broken-deal" expenses and consider differences in investors who participate in co-investment opportunities and how they participate. An investor co-underwriting an investment simultaneously with a manager is markedly different from an investor who is looking at an opportunity as part of a co-investment syndication, particularly an investor such as the CRF who has an extensive internal approval and authorization process. If, in the midst of that process, the adviser's potential investment falls apart, it would be unfair to charge the potential investor for expenses of the adviser. The potential investor and the adviser have not executed any binding contractual agreements, and the potential investor has not received any internal approvals to authorize it to incur liability for such expenses. The CRF encourages the SEC to consider the practicalities and processes of investment transactions in this regard.

In addition to the proposed rule, there are additional prohibited activities that the SEC should consider including in the final rule to improve investor protections.

First, as a general tenet of the private fund industry, the management fees should cover the adviser's overhead. However, we have seen over the years, many advisers shifting their overhead costs to investors on top of their management fee. Typically, this is accomplished by including certain overhead items as a partnership expense, particularly in recent years, allocations for in-house attorney compensation. This is on top of the extensive fund formation legal costs already born by investors (discussed in greater detail below). To protect investors from essentially being charged double (both as a partnership expense and the management fee), we encourage the SEC to consider including a prohibition on the following types of expenses being charged to a private fund and its investors: (a) compensation—salary and benefits—of management company personnel (investment, legal, accounting and compliance professionals and attorneys); (b) management company rent and (c) management company day-to-day costs (such as in-house consultants, information technology, technology systems, data warehousing, accounting systems, and cybersecurity).

In addition, while not all advisers charge the following expenses, the SEC should nonetheless ban expenses not reasonably necessary for the successful operation of a fund such as "entertainment expenses."

The SEC might also consider requiring adviser adoption and disclosure of written expense allocation and control policies to investors. This might provide some means of rationalizing and slowing the

explosion in certain types of expenses that the CRF has witnessed fund over fund, such as organizational expenses.

In addition, private fund terms always include that the fund (*i.e.*, investors) will bear the expenses of counsel that represent the adviser. These are the attorneys who investors negotiate against and who push back on any fund or side letter requests made by the investors. We believe that these attorneys are often the engineers of document provisions and fund structures that are increasingly aggressive and result in reductions to investor protections—all paid for by the investors. With no controls and the ballooning of organizational expenses, the adviser has no incentive to control this expense up to the contractually agreed fee cap that investors foot the entire bill for. This also reflects an inherent conflict of interest in that investors have to bear the expense of fund counsel in their side letter negotiations, *i.e.*, in negotiations against their own interests.

Prohibited Activities: Adviser-Led Secondaries Rule (Proposed Rule 211(h)(2)-2)

The CRF is generally in favor of the proposed requirement that advisers obtain a fairness opinion with respect to adviser-led secondary transactions. We view this as a sensible and prudent practice that provides useful information to investors. It is also a practice that many advisers already follow. The proposed requirement of disclosure of all business ties between the adviser and the provider of the fairness opinion significantly improves the ability of investors to assess more adequately the utility of the opinion.

The CRF would suggest further strengthening the proposed rule by requiring that the fairness opinion be expressly obtained for the benefit of, and addressed to, the fund's *investors,* both those who are cashing out and those who are rolling-over or continuing into the new vehicle. This would clarify for the opinion provider that the opinion is ultimately designed to inform *investor* elections.

In addition, adviser-led secondaries are often complex transactions that get presented to LPACs for approval (because of the conflict issues they present) at a high-level of generality as compared to the level of detail that gets presented to investors thereafter in connection with an election, often in an extraordinarily compressed time frame. We encourage the SEC to consider process and procedural requirements that would (a) allow for meaningful and clear disclosure of all material transaction terms at the LPAC approval stage, as well as (b) ensure requisite time for investors to digest the materials prior to the election being due.

Finally, advisers should also not be allowed to reject and not carry forward relevant side letter provisions to the new investment vehicle when those provisions were already negotiated and accepted by an adviser in respect of the original investment fund. This would be unfair to any investor, but is particularly untenable for public pension plans and other investors who require certain protections in their private fund investments, which were included in their side letters. Advisers should not be allowed to essentially cherry-pick investors for their adviser-led secondary transactions (which transactions often reflect investments which the adviser believes has upside potential) and effectively force out certain investors. Public plans, often because of the size of their commitments, are often in a better position to seek investor-friendly

improvements. Adviser-led secondary transactions should not be an avenue for advisers to get out of side letter terms which they previously agreed to.

Preferential Treatment Rule—Prohibited Preferential Redemptions and Information Rights (Proposed Rule 211(h)(2)-3(a)(1) and (2))

The most problematic of the proposed rules is the rule regarding preferential treatment. This proposed rule would prohibit advisers from granting investors two types of preferential rights, (i) redemption rights on terms that the adviser reasonably expects to have a material, negative effect on other investors and (ii) information rights regarding portfolio holdings or exposures if the adviser reasonably expects providing the information would have a material, negative effect on other investors.

The CRF is subject to various laws, regulations and policies that compel the CRF to seek and procure certain rights with respect to its private fund investments, including the right to redeem from a fund in certain extraordinary circumstances or to obtain specific information and reporting from a fund. The proposed rule proports to disregard sovereign state law and regulation and established investor policies applied consistently across similar investments that require certain information or outcomes to address extraordinary circumstances. Does the SEC intend to diminish access of regulated investors to private investment funds? We fear that this might be the consequence of this proposed rule as statutory, regulatory or policy mandates could be deemed to be providing preferential liquidity or information rights.

We note that long-term institutional investors such as the CRF have an interest in preserving their access to private investment funds and the returns they provide to its portfolio to pay, in the case of the CRF, pension benefits. Therefore, there is little risk that investors like the CRF would take advantage of extraordinary remedies unless dictated by law or policy. In fact, many legal and policy requirements key off of events or circumstances outside of the control of the investor. For example in the context of NYS law prohibiting the CRF from investing with a manager using the services of a placement agent or intermediary to assist the manger in obtaining investments by the CRF and Comptroller DiNapoli's long-standing policy pre-dating this law,[2] it is an *adviser's* violation of this restriction that would give rise to the policy's remedy of freezing investments in the context of closed-end funds or redemption in the case of open-end funds. In sum, the goal of this policy is not to provide CRF with expanded liquidity but to prevent conflicts of interests or the appearance of conflicts of interest by prohibiting the CRF from working with advisers who use the services of a placement agent to assist the adviser in obtaining investments from the CRF. This is but one example of an essential CRF-specific requirement and institutional investors typically have several; therefore, we urge the Commission to consider the disproportionately negative impact this rule could have on institutional investors if advisers are prohibited from agreeing to investor-specific requirements for redemption.

CRF is also concerned that the proposed rule will empower advisers to refuse to provide investors' special terms that may be required for those investors to participate in private funds. Because the rule requires advisers to make the determination of whether a requested provision would have a material, negative effect on the other investors (and therefore be prohibited),

[2] https://www.osc.state.ny.us/files/common-retirement-fund/pdf/placement-agents-policy.pdf

advisers may assert concern over regulatory risk to justify their rejection of fund terms that are required for public pension plans to enter into an investment. As such, the proposed rules would put investors like the CRF in the confounding position of not being able to proceed with a needed investment that it has deemed prudent and has spent a considerable amount of time conducting due diligence on because it is unable to secure its required terms. By way of example, a common provision in the partnership agreement of private funds allows for withdrawal by ERISA investors if there is a regulatory problem (*e.g.*, a violation of ERISA). Would this provision be viewed as a preferential liquidity right for ERISA investors and therefore prohibited by the proposed rule?

The proposed rule regarding information requests has similar problems. Many institutional investors have various investment restrictions, and as such may need information rights about existing investments for various internal compliance requirements (*e.g.*, to ensure that any existing investments do not qualify as investments that the investor is prohibited from participating in). Similar to the legal and policy requirements discussed above in the context of preferential liquidity, information rights are not necessarily meant to give investors enhanced information for liquidity purposes. And in the context of closed-end funds, this information would not lead to preferential liquidity (since investors in closed-end funds do not have liquidity rights).

Another question regarding information rights would be whether this rule would have any effect on what materials an adviser can share with the fund's advisory committee? Given the important role the advisory committee plays regarding conflicts of interest, the proposed rule should not become an obstacle to them.

Given the difficult and disruptive nature of addressing this particular issue, we recommend this proposed rule not be adopted. Or alternatively, we recommend that the proposed rule include explicit language that provisions required by an investor for purposes of compliance with laws, regulations and policies applicable to the investor (and not for purposes of enhanced liquidity) are not prohibited under the SEC's rule. Further, the rule should not leave the determination to the reasonable expectation of the adviser. The SEC should also clarify in the final rule that giving information to investors that are LPAC members in connection with their role as such will not be prohibited by the rule.

The CRF would also note that, to the extent the SEC's goal is to protect smaller investors from receiving worse liquidity provisions, this would be an appropriate place for the SEC to limit the rule to open-end funds. Closed-end funds generally do not offer liquidity to investors and therefore, in light of the unintended consequences described above, the proposed rule, as modified for the allowance for statutory, regulatory and policy provisions, should at the very least, be made inapplicable to closed-end funds.

Preferential Treatment Rule—Prohibited Preferential Transparency, i.e., 'Disclosure Rule' (Proposed Rule 211(h)(2)-3(b))

The CRF finds the proposed rule regarding disclosure of preferential treatment to be of little value and unfeasible from a practical point of view in the closed-end fund space. In addition, the

marketplace has already addressed this concern across the private funds space via "most favored nations" (MFN) provisions.

The proposed rule will be of little value to investors in closed-end funds because it only offers disclosure. While the disclosed information—if received prior to closing—could enable some investors to request additional rights and provisions that they know the adviser has given to other investors, it does not necessarily mean that the adviser will agree to give the same provision to the investor. The same negotiation dynamics discussed earlier will play out, and the investor may find itself in a position of having to commit to a fund with certain terms it doesn't like while not being able to change those terms.

Receiving the disclosure after the investor has closed on a closed-end fund investment leaves the investor in an even worse place. At that point, the investor would have no right to reopen its negotiations over terms. The subscription has already been made and is irrevocable. The side letter has already been executed. The investor would not have any power to request additional provisions. Nor would an investor in a closed-end fund have any ability to withdraw from the fund or cancel its subscription if it objected to the terms that were disclosed. In this situation, disclosure by itself will not necessarily offer meaningful protection to such investors.

As a practical matter, we believe the proposed rule would be unfeasible in the closed-end space. Based on our experience with MFNs, some advisers disclose MFN elections that are hundreds of pages long. Presumably those advisers would do something similar in the context of the proposed SEC rule. Receiving a long disclosure document days before a target closing will be impossible for investors to review and process while leaving little or no time to negotiate additional provisions based on the disclosure. We doubt that many advisers or investors would appreciate added delay in closing. And as a practical matter, how would the rule work when multiple investors subscribe on the same day?

The existing MFN process, as imperfect as it is, is a better approach than the proposed rule. In the MFN approach, investors in closed-end funds receive the disclosure after they close and are allowed to elect certain provisions that the adviser has deemed they are eligible to elect. This gives the investor both information and the power to do something with that information. If the SEC desires to address this issue, we would recommend rulemaking that takes an approach closer to the existing MFN process while fixing its shortcomings (such as limiting the types of provisions an adviser may determine not to be electable by all investors).

We would also ask the SEC to consider whether this proposed rule is designed primarily to address concerns in open-end funds and whether closed-end funds could be exempted.

Emerging Managers.

The CRF has an Emerging Manager Program to identify newer and smaller advisers with the potential to add value to the CRF's portfolio, who may not be identified in the CRF's standard institutional adviser search process. The CRF believes that smaller advisers may generate superior performance returns because of their entrepreneurial nature and increased investment flexibility, and graduates of the Emerging Manager Program are a natural source of new

relationships for the CRF's investment portfolio, allowing the program to organically structure and form new relationships that can evolve to meet institutional investment mandates.

New managers often offer initial investors and anchor investors preferential rights and economics to secure a large commitment early on as a foundation for their remaining fundraising. This practice benefits the adviser by securing a sizable commitment for their fund and benefits the investor by compensating it for the risk of engaging a new adviser. To the extent the proposed rules prohibit or discourage providing preferential rights to investors, it could significantly dampen investors' ability to underwrite such investments and emerging manager access to much needed seed capital.

We urge the SEC to take a close look at the proposed rules and consider any changes that may mitigate overly onerous or negative effects to this important segment of the market for investors.

Conclusion.

We greatly appreciate the SEC's initiative in addressing several issues in the private funds market. And while, to keep our comments as concise as possible, we have focused our comments on places where the proposed rules can be improved, we do believe the proposed rules are an important step in the right direction.

Thank you for your consideration.

Very truly yours,

Anastasia Titarchuk
Chief Investment Officer and Deputy Comptroller
for Pension Investment and Cash Management