The law firms set forth on Appendix A hereto appreciate the opportunity to comment jointly on the above-referenced rule proposal. We comment under the auspices of the Private Investment Funds Forum (the “Forum”). The Forum was founded in 1999 and consists of senior practitioners at the undersigned law firms that represent both emerging and established private fund sponsors, investors, and other private fund market participants.\(^1\)

We write to urge the U.S. Securities and Exchange Commission (the “SEC”) to refrain from adopting the proposed rules.\(^2\) Based on our experience, we believe the SEC has mischaracterized existing market practices, which undermines the policy rationale for advancing the proposed rules. Equally significantly, we believe the SEC has failed to adequately consider the adverse effects of the proposed rules on private fund advisers, private fund investors, other market participants, and the industry as a whole.

We provide below an overview of our comments on the proposed rules, followed by a detailed discussion of our comments, including a brief explanation of our view that the SEC lacks the authority to adopt the proposed rules. Although we focus only on specific aspects of the proposed rules, we do not support the overall proposal. Our decision not to comment on certain sections of the proposed rules should not be viewed as an implicit endorsement of those

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\(^1\) This letter reflects the consensus views of the undersigned law firms. The views expressed in this letter do not necessarily reflect the views of any individual member of the Forum, any organizations with which any Forum member is associated, or any clients or any particular client constituency of such members or the undersigned law firms.

\(^2\) Unless otherwise noted, for purposes of this letter, “proposed rules” means (i) the proposed new rules 211(h)(1)-1, 211(h)(1)-2, 211(h)(2)-1, 211(h)(2)-2, 211(h)(2)-3, and 206(4)-10 under the U.S. Investment Advisers Act of 1940 (“Advisers Act”); (ii) the proposed amendments to rule 204-2 under the Advisers Act; and (iii) the proposed amendments to rule 206(4)-7 under the Advisers Act.
sections. To the contrary, we believe the entire rule proposal is unnecessary and fundamentally flawed and that it will impose unjustified costs and constraints on both advisers and investors. Therefore, we propose that the SEC should withdraw the proposed rules and not proceed to a final rule.

I. Introduction and Overview

- We and our clients support transparency in the private funds marketplace. In our collective experience, private fund investors receive significant transparency about their fund investments, and they frequently negotiate for customized disclosures from the fund’s sponsor to meet their needs.
  - We strongly support the notion that private fund investors should, and do, benefit from transparency. We believe our private fund adviser clients support this notion, and we facilitate thousands of negotiations each year between sponsors and investors where the parties work out the scope of transparency. Although we acknowledge that the SEC has the authority to promulgate certain disclosure rules applicable to private fund advisers, we believe that the SEC should not dictate rigid forms of disclosure that apply to all private funds.
  - Congress, through the federal securities laws, and the SEC itself, recognize that private fund investors are sufficiently sophisticated to be able to determine whether or not to make an investment in a private fund, and those investors and their counsel frequently negotiate the disclosures for such an investment. There is no reason for the SEC to impose retail investor-style disclosures in such an environment.

- The proposal does not accurately describe the private fund marketplace as it exists today. The private fund industry has evolved significantly since 2015, after the SEC brought several settled enforcement actions that had the effect of changing practices in the industry.
  - In the years since, private fund advisers have worked with their investors and their counsel to address conflicts of interest and respond to requests for increased transparency. In our experience, looking at the private fund marketplace today, private fund advisers and investors have largely remedied the issues that the proposed rules are largely designed to address. For example, many private fund advisers adopted, in whole or in large part, the disclosure guidelines and template promoted by the Institutional Limited Partners Association (“ILPA”).
  - As a result of these changes, the private fund industry has become an increasingly desirable market for investor capital. Investors have increased their allocations to private funds and many new fund advisers have entered the already-crowded market.
  - Because the Proposing Release does not accurately describe the existing dynamic between private fund advisers and investors, it does not accurately assess whether the proposed rules would materially benefit private fund investors, on balance, when compared to existing market practice. Instead, the proposal seeks to impose registered fund-like disclosure and conflicts obligations on private funds. This effort is a departure
from the SEC’s historical view, consistently repeated in recent SEC and staff pronouncements, that private fund investors that meet the eligibility criteria have the wherewithal to negotiate adequate protections for their investment, or to determine whether or not to invest based on the mix of terms of the investment.

- **The proposed rules, if adopted, will have significant negative consequences, many of which the SEC has neither identified nor analyzed.**
  
  - We believe that the proposed rules will serve as a barrier to entry. The private fund industry has been built on innovation. Consistent with its mission of facilitating capital formation, the SEC should encourage — or at a minimum, not impede — new managers and new strategies. Higher costs to operate funds will increase barriers to entry for smaller fund sponsors, which are more likely than large fund sponsors to accept investors with lower subscription minimums. Many smaller sponsors will not be able to raise enough capital to support additional compliance costs and will not be able to absorb the risk of a highly variable expense item. Thus the proposed rules would disproportionately burden such new entrants and could negatively impact the ability of smaller and new asset managers to enter the field. Before it moves forward with any final rule, we encourage the SEC to conduct a careful analysis of this disparate impact.
  
  - A reduction in the number of private fund advisers as a result of increasing the costs of operating private funds will likely decrease access to capital for portfolio companies, including those that are underperforming, those that are in distress, and those in need of growth capital. Private funds represent an essential source of capital for such companies. For example, middle-market private firms closed 2,847 middle-market buyouts through September 30, 2021 for a combined $438.6 billion.³

- **The SEC should not insert itself into commercial negotiations between sophisticated parties.** When sophisticated investors and fund sponsors are free to negotiate, they can arrive at arrangements that make economic sense to all parties. The proposed rules risk thwarting this process through governmental interference.
  
  - The economic terms of private funds have been shaped by the allocation of expenses and risks between advisers and investors over the course of years of negotiations.

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³ Based on data from PitchBook. It is difficult to determine precisely how much private capital is invested into “middle-market” companies, but there is good reason to believe that the PitchBook data shown above substantially underestimates the size and importance of this market. If the private credit asset class (including “middle-market” credit) is $1 trillion in size, as many commentators have suggested, total capital deployed by private funds, assuming a 45% equity cushion, would be $1.8 trillion. In any case, it is clear that private funds are raising and deploying records amounts of capital into middle-market companies. See also Investor Executive, Investors sunk over US$1 trillion into private markets in 2021: McKinsey (March 24, 2022), available at: www.investmentexecutive.com/news/research-and-markets/investors-sunk-over-us1-trillion-into-private-markets-in-2021-mckinsey (“Worldwide, private markets fundraising was $1.184 trillion in 2021, up by nearly 20% from $990 billion in 2020 and 1.6% from $1.166 trillion in 2019, according to the McKinsey Global Private Markets Review 2022.”).
• Prohibiting particular terms and mandating others is not appropriate in the context of commercial negotiations between sophisticated parties.

• The proposed rules will increase adviser liability for business judgments made in good faith that would have otherwise been appropriately protected.

• **Any final rule must exempt pre-existing funds and provide a reasonable compliance period to allow market participants to adjust to the terms of that rule.** The proposed rules, if adopted, would change the risk and economic terms of countless private funds. Applying new rules to pre-existing private funds would unfairly change the negotiated economic arrangement without an ability for the private fund adviser to take action to protect its interests. In a private fund setting, a negotiated deal is struck at closing, and that deal represented a meeting of the minds among sophisticated parties. Later eliminating one provision based on a new rule is not a surgical exercise. The entire deal would need to be revisited and renegotiated.

• **If adopted, the rules should be narrowed in scope and in particular should not apply with respect to a non-U.S. adviser’s private funds organized outside of the United States.** We urge the SEC not to adopt the proposed rules. However, if the SEC adopts the proposed rules, the SEC should exempt all unregistered advisers and should explicitly exclude from the entire rulemaking package (not just the prohibited activities rule) non-U.S. advisers with respect to non-U.S. funds, consistent with the decades-long SEC position that the substantive provisions of the Advisers Act do not apply to non-U.S. advisers with respect to non-U.S. clients.

• **Section 211(h) of the Advisers Act does not grant the SEC authority to adopt rules for private fund advisers.** The SEC merely asserts Section 211(h) of the Advisers Act as providing authority to adopt rules targeting private fund advisers, but provides no analysis of that authority. None of Section 211(h), any other provision of Section 211, nor Section 913(g) of the Dodd-Frank Act (which added Section 211 to the Advisers Act) refer to, or provide the SEC authority with respect to, private fund advisers.

II. **Retroactive Application**

We believe that the proposed rules exceed the SEC’s authority by applying to existing contractual arrangements, some of which were entered into decades ago, without any exemption or accommodation. The SEC cannot enact rules with retroactive effect unless Congress gives the SEC the power to do so in clear and unmistakable terms. Here, none of the statutory provisions on which the SEC relies expressly grants it the power to promulgate retroactive rules. If adopted, the proposed rules would prohibit private fund advisers from fulfilling their contractual obligations, would impose material costs on advisers and investors, and would interfere with existing rights under highly negotiated contracts.

In addition to being impermissibly retroactive, the proposed rules do not provide sufficient time for private funds to conform to the rules, and the Proposing Release grossly underestimates the cost of retroactive compliance for both advisers and investors. The proposed one-year conformance period does not provide sufficient time to make required changes, and the
compressed timeframe will also likely lead to increased costs and expenses for private fund advisers not adequately captured in SEC’s cost/benefit analysis. We believe that the SEC also ignores the significant costs for investors who invest in private funds. Many, if not most, private fund governing agreements and side letters cannot be unilaterally amended by the adviser, which means that each adviser, on a fund-by-fund basis, will be required to renegotiate existing side letters and other governing documents with investors in order to receive required amendment approvals by the end of the proposed one-year conformance period. Beyond the costs of complying with the final rule, we expect significant complexity and uncertainty in interpreting and applying the Proposed Rules.

Any final rules adopted by the SEC should (i) “grandfather” all pre-existing private fund contracts (including fund governing documents, advisory agreements, and side letters) and (ii) provide an extended and reasonable conformance period as was adopted for the 2020 modernization amendments to the Advisers Act’s marketing rule (Rule 206(4)-1) (the “Marketing Rule”).

III. Specific Comments on the Proposed Rules

A. The SEC should not adopt Proposed Rule 211(h)(2)-1: Private fund adviser prohibited activities.4

The proposed rule prohibits a series of actions by private fund advisers. We comment on the proposed restrictions below.

1. Proposed Rule 211(h)(2)-1(a)(5): Prohibition on seeking reimbursement, indemnification, exculpation, or limitation of 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.

We strongly disagree with the appropriateness and policy rationale for the proposed rule. If adopted, the proposed rule would allow private fund investors and other would-be plaintiffs to second-guess private fund advisers for good faith investment and business decisions. Enacting the proposed rule would cause more harm than good to advisers, investors, and other market participants. As a result, we believe that adopting the proposed rule would be arbitrary and capricious.

i. The proposed rule is inconsistent with well-developed market practice and with the structure of the federal securities laws.

To be clear, in our experience, private fund advisers do not and should not seek exculpation or indemnification for “willful misfeasance” or “bad faith.” Our concern is the proposed elimination of the gross negligence standard in the context of commercially negotiated terms with sophisticated investors in the context of private — not retail — funds. The terms of private funds are the result of these negotiations. Investors and highly specialized fund- and

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4 For purposes of this Section III.A, the “proposed rule” refers to the relevant subpart of § 275.211(h)(2)-1 and the relevant definitions in § 275.211(h)(1)-1.
investor-counsel are well aware of what has been agreed. When investors and advisers are free to negotiate, they can arrive at arrangements that make economic sense to all parties. The proposed rules risk thwarting this process.

In particular, eliminating liability protection for ordinary negligence not only dramatically shifts the risk from what has been agreed in virtually all existing arrangements; it is markedly inconsistent with the federal securities laws. Under the federal securities laws — as embodied in the Securities Exchange Act of 1934 (“Exchange Act”) and the rules promulgated thereunder — a private litigant cannot recover monetary damages for merely negligent conduct. Rather, a private litigant must allege and prove that a defendant acted with scienter (i.e., a mental state embracing intent to deceive, manipulate, or defraud) in order to state a claim for damages under the Exchange Act’s principal liability provisions, namely, Section 10(b) and Rule 10b-5. That standard means that, in the normal course of running their businesses, even a public company’s employees, including its executives, will not be liable to private litigants under the federal securities laws unless they act with scienter. Importantly, this includes virtually all of these officers’ day-to-day communications with current and prospective shareholders, including communications via press releases, quarterly reports and earnings calls, investor conferences, SEC filings such as Forms 8-K, 10-Q and 10-K, and oral conversations with investors. In particular, private fund advisers that take control positions of portfolio companies or otherwise engage in the actual day-to-day operations of portfolio companies are placed at a heightened risk of exposure to litigation that is currently mitigated by relying on the gross negligence standard of the indemnity and exculpation provisions.

What makes the proposed rule particularly difficult to understand is the fact that the Exchange Act (including Section 10(b) and Rule 10b-5) is intended to protect all investors, including so-called “mom and pop” retail investors. Conversely, all investors in the private investment funds or vehicles at issue are qualified purchasers or accredited investors who are well equipped to assess the risks associated with contractual provisions regarding exculpation and indemnification for ordinary negligence. Many of these investors have the negotiating power to (and in fact do) negotiate these provisions, making their own decisions as to how and where and on what issues to deploy that negotiating and bargaining power. Against this backdrop, it seems incongruous that, under the federal securities laws, private litigants may generally only sue for misleading statements or omissions upon a showing of scienter, and at the same time the SEC is proposing a rule that would prohibit far more sophisticated parties from entering into a contractual agreement for the exculpation and indemnification of private fund advisers for ordinary negligence.

In sum, the proposal regarding negligence would upend decades of settled market practice and expectations. Moreover, it would do so by applying a standard inconsistently as compared to other statutory and rule provisions in the federal securities laws.

   ii. An SEC prohibition of particular terms is not appropriate in the context of commercial negotiations between sophisticated parties.

Many of these sophisticated investors (i.e., endowments and pensions) have used significant bargaining power to shape duties, indemnities, and exculpation provisions. Private fund advisers and investors have actively negotiated these standards and carve outs over several
decades. Even in funds-of-one, these standards are prevalent. Regardless of their market power to negotiate terms, at a minimum these investors have the sophistication to determine whether or not to invest — if such an investor disagrees with the risk profile of the fund and the terms, including the appropriate indemnification and liability standards, that investor can simply walk away from the investment opportunity.

From a policy perspective, we believe that a prohibition of reimbursement, indemnification, exculpation, or limitation of liability is inappropriate and harmful. Allowing private fund advisers to limit their liability while acting in good faith allows them to make investment and business decisions without fearing potentially baseless litigation if the investment does not perform as desired. Performance can be driven by a multitude of factors that are beyond a private fund adviser’s control — macro- and micro-economic factors, geopolitical developments, market whims, and other factors. Protecting private funds and their advisers from the risk of litigation for after-the-fact performance developments, when the adviser acted in good faith or restricted in exercising its business judgment, is entirely appropriate and should not be prohibited by the SEC. Further, the SEC does not describe the types of behaviors it seeks to remedy with the proposed rule and does not explain how investors are being harmed as a result of the traditional gross negligence standard of liability. Instead, the SEC simply asserts, without analysis, that negligent behavior is “adviser misconduct” unworthy of indemnification or exculpation. The SEC does not consider the ways in which the incentives of advisers and their personnel are aligned with those of the investors to avoid actual misconduct (e.g., through incentive compensation structures, general partner commitments to the funds which constitute the personal wealth of adviser personnel).

The SEC notes that its underlying priority in promulgating the proposed rule is protecting retail investors. However, it is institutional and other ultra-high net worth investors, not retail investors, who comprise a substantial majority of the capital in private funds. In the case of the retail investors who invest indirectly in private funds, they are typically represented by a larger institutional investor with a fiduciary duty to, and the resources to protect and act on behalf of, those underlying investors.

In short, there is little reason to disturb the longstanding ability of advisers to negotiate with sophisticated investors for the contractual reduction of the adviser’s potential exposure to endless litigation over close fiduciary calls, especially bearing in mind that advisers are never permitted to agree contractually to free themselves of the obligation to act at all times in good faith and to engage in fair dealing.

iii. The proposed rule disregards — and appears to seek to preempt — state fiduciary law.

The SEC does not make clear whether it is seeking to preempt state law. It appears to us that the effect would be preemption of state law fiduciary duty arrangements. While the Advisers Act authorizes the SEC to enforce an investment adviser’s fiduciary duty relative to its clients (i.e., the private funds themselves), the substance and contours of an investment adviser’s fiduciary duty — whether as a general partner or manager to its private funds — arise from state law. Under Delaware law, for example, it is clear that a private fund adviser’s fiduciary duty to
the fund’s investors is violated only where the alleged lack of care amounts to gross negligence.5 Private fund advisers should not be liable for negligence under federal law if they can be held harmless for the same negligence under the applicable state law. While the SEC discusses its interpretation that Advisers Act fiduciary duties cannot be waived, it does not discuss the substance of the Advisers Act fiduciary duty and what justification exists to interpret the substance of the fiduciary duty differently from applicable state laws.

iv. The proposed rule undermines fundamental tenets of the Advisers Act and SEC Staff guidance.

The proposed rule is directionally opposed to the SEC’s own interpretive guidance regarding hedge clauses issued only two years ago describing an investment adviser’s fiduciary duties.6 That guidance codified Advisers Act interpretations that have been respected by the SEC for decades. It articulated the notion that an adviser’s fiduciary duty follows the contours of the relationship between the adviser and its client, which may be shaped by agreement provided there is full and fair disclosure and informed consent. The SEC has not alleged that there is not full and fair disclosure to, and informed consent from, investors with regard to the applicable standards of conduct. Further, the SEC does not identify any market practice that has developed since 2019 that would justify such a dramatic departure from its own guidance, nor does it explain a rationale for that change. The Goldstein decision overturned an SEC rule that had a similar change of a long-standing SEC interpretation.

In addition, the proposed rule has the effect of creating new private rights of action for damages pursuant to the Advisers Act. This is plainly contrary to the Supreme Court’s 1979 holding in Transamerica Mortgage Advisors, Inc. v. Lewis that there is no private right of action for damages under the Advisers Act. Due to passage of time without Congressional override, despite repeated amendments to other provisions of the Advisers Act, this holding has the force of statutory law, and the SEC does not have the authority overturn it.

v. The proposed rule is arbitrary and capricious.

The SEC does not adequately identify or discuss any of the alternative regulatory frameworks applicable to other issuers or even other investment products under the Investment Company Act of 1940 (“Investment Company Act”). Specifically, the proposed rule would establish stricter liability standards relative to institutional investors than the protections provided to retail investors under the Investment Company Act and elsewhere under the federal securities laws. Applying more stringent restrictions to institutional investors as compared to retail investors is arbitrary and capricious, particularly given the SEC does not describe or justify the disparate treatment that is in contravention of the Investment Company Act, which has

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exempted private funds from registration under the Investment Company Act based on the sophistication of their investors.

vi. *The SEC has not sufficiently analyzed the economic consequences of the proposed rule.*

In exchange for contractually agreeing to such provisions, private fund investors implicitly receive more favorable terms on other provisions, potentially including fees, pricing, and other harder-to-quantify terms. Stated differently, if private fund advisers were required, contrary to express state law and decades of prevailing market practice, to be monetarily liable to private litigants for every risk-based investment decision (with potentially ceaseless litigation), rational commercial behavior dictates that there would be a tradeoff resulting in the adviser requiring and receiving various other more-favorable deal terms to compensate the adviser for assuming the additional business risks created by the proposed rule. Furthermore, if existing contracts are made subject to this prohibition, advisers may not be able to re-negotiate the economic terms in order to balance out the increased liability costs, locking in the adviser’s disadvantageous economic position for the life of pre-existing private funds.

Substantially all private fund managers maintain liability insurance policies, which typically have hefty premiums and high retentions (deductibles). The proposed rule will undoubtedly result in very substantial increases in these insurance costs and, as described earlier, serve as a barrier to entry to new and smaller advisers that may not be able to obtain appropriate insurance coverage. The failure of the economic analysis to make any attempt to quantify these costs is a defect that must be addressed and fairly evaluated.

The SEC must perform a more robust economic analysis that acknowledges the costs and burdens on private fund advisers. In particular, the proposed rule could make it very difficult for smaller fund managers to maintain operations or enter the industry because it would impose prohibitive risks, costs and uncertainties, thereby eliminating competition and innovation. The SEC’s cursory economic analysis of the proposed rule does not contemplate, much less seek to quantify, the extraordinary cost to private fund advisers, and the potential disruption to the private fund marketplace, if the SEC were to adopt the proposed rule. Courts have stricken rules proposed by the SEC without appropriately detailed economic analysis.

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7 See, e.g., *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (“The Commission has a unique obligation to consider the effect of a new rule upon ‘efficiency, competition, and capital formation,’ 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a–2(c), and its failure to ‘apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation’ makes promulgation of the rule arbitrary and capricious and not in accordance with law.”) Other portions of the proposed rules suffer similar deficiencies in economic analysis. While the SEC’s economic analysis does recognize some costs and burdens associated with the proposed rules, it does not attempt to quantify those costs or adequately consider the impact of the proposed rules on market practice.
2. **Proposed Rule 211(h)(2)-1(a)(4): Prohibition on reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.**

We believe that the SEC fundamentally misunderstands how after-tax clawbacks typically operate, and the SEC’s clawback descriptions are inconsistent with how most private funds structure their clawback provisions. We believe that the SEC has not sufficiently analyzed the proposed rule and that this is an example of why the SEC should not attempt to regulate economic terms negotiated at arm’s-length by private fund advisers and investors and their respective counsel.

Performance-based distributions from a private fund are commonly structured as profits allocations to the adviser or a related person. This arrangement benefits the private fund’s non-corporate U.S. taxable investors, among other ways, because they are able to receive an effective deduction for the carried interest, whereas if the distributions were structured as a fee, the amount would likely be treated as a “miscellaneous itemized deduction” and therefore not be deductible for such investors. The profit allocations also provides an effective means for a private fund adviser to structure compensation arrangements to incentivize its investment professionals in alignment with the fund’s investors.

An important consequence of the profits allocation structure is that the recipient (and typically its direct or indirect owners) is allocated taxable income (and therefore incurs a tax liability) early in the private fund’s life, often well before the recipient is entitled to carried interest distributions under the fund’s operating agreement. As a result, many agreements permit the carried interest recipient to receive an “advance” of its carried interest, in an amount sufficient to pay its tax liability arising from such taxable income allocations. Because it is not always possible to know the precise tax profile of each indirect owner of the carried interest recipient, a hypothetical tax rate is used, typically assuming that the owner is an individual resident in one of the jurisdictions in which the adviser has an office. This arrangement helps align the incentives of the adviser with those of the investors, by ensuring that the adviser’s investment decisions can be made without the adviser being concerned that it or its owners will not have the cash sufficient to pay taxes on the carried interest as a result of the adviser’s investment decisions.

In certain cases, the recipient of profit allocations may receive more carried interest distributions (often, in the form of the tax “advances” discussed above) than it would be entitled to under the hypothetical circumstance in which all the private fund’s investments were realized at the same time. This could be the case, for example, when a fund disposes of gain investments early in its term and loss investments late in its term. In such a case, the recipient is typically required to return the excess amount to the fund (*i.e.*, the “clawback”), but not in an amount exceeding the after-tax carried interest.

Taxable losses (whether arising from loss investments or the payment of the carried interest clawback obligation itself) allocated to a carried interest recipient are often not readily usable, for at least two reasons. First, the losses are typically capital losses, which for an individual can be used to offset only capital gain (and a small amount of ordinary income), if any, in a given taxable year. Second, the losses cannot be carried back by an individual to prior
taxable years, so any unused losses must be carried forward until a future year (if any) in which
the individual recognizes taxable gains that can be offset by such losses.

Because a significant portion of the carried interest recipient is often owned by
investment professionals, determining whether a loss is actually utilized (whether in the current
year or in a subsequent year) would require the adviser to access the professionals’ individual tax
returns, which is an intrusive requirement for an employer to impose on an employee. Moreover,
because the clawback may take place many years after the private fund launched, some of these
professionals may have moved on to other jobs, and so this determination may require
cooperation between the adviser and its former employees.

Requiring the gross amount of the over-distribution of carried interest to be clawed back
will therefore often require the adviser or its employees to come out of pocket to fund the
clawback, and in some cases may leave the recipient worse off than if they had never received a
carried interest award in the first place.

If the SEC were to adopt the proposed rule, it would create numerous incentives that may
inadvertently harm investors. The proposed rule, if adopted, may require some advisers to
increase the fixed fee compensation (i.e., the management fee), to fund a reserve to compensate
its employees who would otherwise have to come out-of-pocket to fund a carried interest
clawback. The proposed rule, if adopted, also would incentivize some advisers to switch to an
incentive fee structure, which may result in: (a) worse after-tax results for non-corporate U.S.
taxable investors; (b) limitations on the ability to structure deferred incentive arrangements that
align the interests of carried interest recipients with investors; and (c) higher taxes to the carried
interest recipients (which may accordingly require a higher carried interest rate to compensate
for the increased taxes).

Because the proposed rule would adversely affect private fund advisers and investors
alike, and because the SEC did not analyze these consequences, we urge the SEC not to adopt
the proposed rule.

3. Proposed Rule 211(h)(2)-1(a)(6): Prohibition on charging or allocating fees
and expenses related to a portfolio investment (or potential portfolio investment)
on a non-pro rata basis when multiple private funds and other clients advised
by the adviser or its related persons have invested (or propose to invest) in the
same portfolio investment.

The proposed prohibition on non-pro-rata allocations (allocation of broken deal expenses,
for example) will hinder private funds’ ability to consummate investments because co-
investment capital will be significantly more difficult to attract, particularly where existing
expenses are significant. In transactions with meaningful existing expenses and fees, it will be
more difficult to syndicate or raise capital, to the detriment of fund investors.

If the proposed rule is adopted, co-investors will be incentivized to wait to commit until
there is certainty in the deal. That is an adverse outcome for the private fund as it means the
private fund will take a disproportionate amount of risk on the deal for much longer. Today,
fund sponsors typically seek to de-risk the private fund as soon as possible by having co-
investors sign onto a deal as early as possible in the process (sometimes before a deal is even signed). However, this is not always possible, and sometimes it is in the best interest of a fund and its investors to accept co-investment capital from sources that do not agree to share in expenses, in order to obtain the necessary capital to complete the transaction. (We note that lenders — another possible source of financing — would not bear broken deal fees; imposing a different standard for equity capital appears to be artificial and unnecessarily limiting.)

In any case, private fund investors are well served by advisers having flexibility to manage co-investment allocations and related costs. For example, a private fund materially benefits when potential co-investors are not guaranteed any investment allocations until the deal is very mature. Lining up potential co-investors without guaranteeing any particular allocations enables the private fund to compete for deals under many different sizing scenarios, including where the private fund adviser does not know the size of the proposed deal. The tradeoff for the private fund — and what co-investors often (reasonably) insist on — is that if the deal falls away, or the private fund loses its bid, the broken deal fees are borne by the fund (i.e., the party that had a guaranteed allocation). In addition, the proposal is unworkable for a large number of state and corporate pension plans in the U.S., who are unable to commit to expense sharing without undergoing the full internal approval process that is necessary to underwrite the full transaction but is unlikely to be accomplished on the compressed timelines needed to take advantage of co-investment opportunities.

The proposed rule may also serve to depress the availability of co-investment opportunities to private fund investors, which such investors value as a means to hasten their capital deployment, increase exposure to particular industries/sectors, and blend down the overall economics paid to the private fund adviser.


The proposed rule is intended to address specific types of preferential treatment by prohibiting all private fund advisers (whether or not registered) from:

(i) entering into arrangements (through side letters or otherwise) that would provide preferential redemption rights or information regarding the portfolio holdings or exposures of the private fund such that the fund adviser reasonably expects the redemption rights or provision of information, as applicable, to have a material, negative effect on other investors in the private fund; and

(ii) providing any other preferential treatment to any investor in the private fund unless the adviser provides written notice to (a) prospective investors in the private fund, prior to any such investor’s investment in the private fund and (b) existing investors (on an annual basis) that includes specific information

8 For purposes of this Section III.B, the “proposed rule” refers to § 275.211(h)(2)-3 and the relevant definitions in § 275.211(h)(1)-1.
regarding any preferential treatment afforded to other investors in the same private fund.

The Proposing Release states that, for purposes of the proposed rule, whether a fund adviser could have a reasonable expectation that a preferential term would have a material, negative effect on other investors in the same private fund depends on the facts and circumstances. Registered fund advisers would also be required to retain books and records to support their compliance with the proposed rule.

1. **The proposed rule is excessive in comparison to historical concerns.**

The Proposing Release is clear about SEC concerns regarding preferential liquidity and access to portfolio information afforded certain private fund investors. The Proposing Release also acknowledges that certain preferential treatment does not necessarily disadvantage other private fund investors, but suggests that advance disclosure is necessary to allow private fund investors to make their own assessment.

The SEC’s concerns are neither new nor endemic to recently adopted industry practices. As an example, the primary concerns articulated by the SEC, in many important respects, echo testimony originally offered by Susan Ferris Wyderko, the SEC’s then Director, Office of Investor Education and Assistance, before the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs on May 16, 2006 (the “2006 Testimony”). In the 2006 Testimony, Director Wyderko noted that “[s]ome side letters address matters that raise few concerns, such as the ability to make additional investments, receive treatment as favorable as other investors, or limit management fees and incentives. Others, however, are more troubling because they may involve material conflicts of interest that can harm the interests of other investors. Chief among these types of side letter agreements are those that give certain investors liquidity preferences or provide them with more access to portfolio information.”

The SEC examination priorities outlined in the 2006 Testimony have remained a perennial exam focus for more than a decade. On June 23, 2020, the Division of Examinations released a Risk Alert titled *Observations from Examinations of Investment Advisers Managing Private Funds* (the “2020 Examination Observations”) noting that “[t]he staff observed private fund advisers that entered into [side letters] that established special terms, including preferential liquidity terms, but did not provide adequate disclosure about these side letters. As a result, some investors were unaware of the potential harm that could be caused if the selected investors exercised the special terms granted by the side letters. Similarly, the staff observed private fund advisers that set up undisclosed side-by-side vehicles or SMAs that invested alongside the flagship fund, but had preferential liquidity terms. Failure to disclose these special terms adequately meant that some investors were unaware of the potential harm that could be caused by selected investors redeeming their investments ahead of other investors, particularly in times of market dislocation where there is a greater likelihood of a financial impact.”
The SEC Staff’s primary focus historically has been on preferential terms and information rights that could position certain investors in liquid (open-ended) private funds to redeem ahead of others to the material detriment of such other investors. The proposed rule, by contrast, goes much further. It not only prohibits a private fund adviser from granting preferential redemption or information rights that the adviser reasonably expects to have a material, negative effect on other investors; it requires advance written notice to prospective investors in both liquid and illiquid funds of all preferential treatment, regardless of whether such treatment has a material, negative effect (or indeed, any effect) on other investors in a private fund.

Moreover, requiring advance disclosure of preferential redemption and information rights would allow private fund investors to second-guess an adviser’s good faith determination that such rights, when granted, were not expected to have a material, negative effect on other investors. Advisers will therefore be incentivized not to offer any preferential redemption or information rights, even for legitimate reasons, to protect themselves against post-hoc claims (e.g., if the fund underperforms) that they violated the proposed rule by granting those rights. Ironically, the proposed rule could result in less transparency and liquidity for the investors the SEC seeks to protect, including pension funds and U.S. state sovereigns that often require special information or liquidity rights in order to invest in private funds.

2. The proposed rule would have unintended adverse consequences.

Prohibiting preferential redemption rights reasonably expected to have a material, negative effect on other investors in the private fund or in a substantially similar pool of assets raises the question as to whether certain liquidity rights granted due to regulatory constraints (the Bank Holding Company Act of 1956 and the U.S. Employee Retirement Income Security Act of 1974, among others), violations of statutory restrictions (e.g., anti-boycott or pay-to-play violations), tax limitations, or internal policies that impose percentage ownership limitations would cause a private fund adviser to violate the proposed rule.

Similarly, prohibiting preferential information rights reasonably expected to have a material, negative effect on other investors in the private fund or in a substantially similar pool of assets raises the question as to whether customized reporting provisions regularly required by institutional investors, including based on state or other legal regulations, in private funds could negatively impact other investors, even in illiquid private funds where such information would not generally facilitate any sort of redemption right (other than for illegality or regulatory constraints, or a potential decision to sell an interest in the fund to a third party). Due to the expense associated with providing such customized reporting, it would be impractical or financially burdensome for a fund to provide all investors with such customized reporting, potentially leaving the private fund adviser in a position in which it would need to reject a number of the customized reporting requests that many institutional investors view as prerequisites to considering a private fund investment opportunity. The proposal, if adopted,
also would result in an increased cost to sponsoring and managing a fund, which costs ultimately would be borne by fund investors.

As noted above, the upshot of the proposed rule could well be that private fund advisers stop offering any preferential redemption or information rights, even benign rights that certain investors cannot invest without.

Perhaps one of the most harmful potential consequences of the proposed rule is the impact the advance side letter disclosure requirement could have on the fundraising process, particularly for illiquid private funds. An illiquid private fund typically raises capital over a period of time with multiple closings, and relies upon side letters to address the bespoke concerns of particular investors.

Side letters are typically subject to “most favored nation” or “MFN” provisions that allow other investors with the same or a greater commitment to the private fund to elect the benefit of provisions in another investor’s side letter that are germane to them, subject to customary carve-outs. Ordinary-course side letter provisions routinely requested by investors include:

(i) the right to receive bespoke reporting;

(ii) the right to appoint a representative to a private fund’s limited partner advisory committee;

(iii) the ability to be excused from certain types of investments prohibited by applicable law or internal policy;

(iv) the right to disclose certain information received from the private fund (to satisfy public disclosure requirements or obligations to feeder or fund-of-funds investors, for example);

(v) the right to transfer an interest with greater flexibility than contemplated by the private fund’s governing agreement; and

(vi) the right to certain protections based on the specific legal, regulatory or tax status of an investor.

A side letter is meant to supplement or modify certain terms of a private fund’s governing agreement, solely with respect to the investor who is the recipient of the side letter. State or local contractual law imposes limitations on the enforceability of a side letter that purports to afford one investor rights that would impact other investors in a manner not contemplated by the private fund’s governing agreement.

While certain investors may ask to review other side letters prior to investing, more frequently the MFN process is facilitated by the private fund adviser agreeing to distribute the
fully negotiated side letters or a compendium that eliminates duplicative or repetitive provisions to all of the investors with MFN rights after the private fund’s final closing.

This process creates greater efficiency and reduces the burden on investors seeking to exercise their MFN rights. It also ensures that no investor is electing rights on a piecemeal basis and that investors participating in later closings are not better positioned than investors participating in earlier closings. Moreover, nothing about the existing process deprives prospective investors the right to inquire about existing side letters or to request specific side letter provisions in order to make the investment attractive/viable for them.

Conversely, advance disclosure would protract the closing process and prevent early (or “anchor” closings) because investors would require additional time prior to closing to review other side letters. Advance disclosure would also generate potentially significant additional legal expense that would be borne by all fund investors, including those who considered the investment terms to be acceptable without any side letter provisions. As a practical matter, advance disclosure would only afford investors participating in earlier closings access to a subset of the side letter rights ultimately agreed by the private fund manager prior to making an investment decision.

Such a process would necessarily reduce the number of provisions a private fund adviser would reasonably be expected to agree via side letter to the detriment of investors, particularly smaller investors with less negotiating leverage.

3. The SEC should not adopt any version of the proposed rule; however, if the SEC seeks to adopt a final rule, it must at the very least substantially revise the proposed rule.

As with the entirety of the proposal, the proposed rule must be subject to a grandfathering provision such that it would only apply to private fund advisers with respect to private funds launching (holding initial closings) after the effective date of the rule and would not apply retroactively to existing arrangements (including, in a number of instances, existing arrangements entered into by unregistered private fund advisers).

The proposed rule must be modified to make clear that (a) customized reporting provisions regularly requested by institutional investors and (b) rights of redemption / withdrawal afforded investors in both liquid and illiquid private funds via side letter to address regulatory constraints, violations of statutory restrictions, tax limitations, or internal policies that impose percentage ownership limitations should be deemed not to have a material, negative effect on other investors.

The proposed rule must be modified to require advance disclosure only of certain specified categories of provisions that may be entered into with certain investors via side letter and disclosure of specific provisions to all private fund investors subsequent to the private fund’s final closing (or annually in the case of a liquid fund). This approach would be consistent with
the preferential treatment rules applicable to private fund advisers that are subject to the Alternative Investment Fund Managers Directive (2011/61/EU; “AIFMD”). The approach would also align with the July 2020 Institutional Limited Partners Association (“ILPA”) Model Limited Partnership Agreement, which includes a customary MFN provision contemplating that private fund advisers notice investors of side letter provisions after the private fund’s final closing.

The SEC should make clear that references to “substantially similar pools of assets” refers to private funds, not all investment vehicles.

In addition, the SEC should confirm that the proposed rule does not prohibit a private fund from offering multiple share classes with different liquidity features. For example, the proposed rule, if adopted, might prevent “seed” investments by private fund advisers and their related persons. New advisers in particular rely extensively on seed capital arrangements to secure adequate capital and institutional endorsement to facilitate the launch of a new private fund enterprise. Seed capital providers typically agree to a “hard” initial lock-up of two to three

9 In summary, Article 12(1) of the AIFMD states that “no investor in an AIF shall obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF’s rules or instruments of incorporation.” Additionally, Article 23 of the AIFMD, which also applies to non-EEA AIFMs when marketing funds in the EEA, requires investors to be provided with a “description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investors who obtain such preferential treatment and, where relevant, their legal or economic links with the AIF or AIFM.” This disclosure obligation applies prior to investment and following any material changes to such preferential treatment. This can be achieved through broad disclosure in the private placement memorandum or governing agreement, and if any side letter provisions are entered into which do not fall within the disclosure provided regarding preferential treatment in the private placement memorandum or governing agreement, the disclosure would be updated in a supplement to the private placement memorandum or an amendment to the governing agreement. The ability to request further information from the manager is also commonly included in the private placement memorandum, with summaries of side letter rights typically made available after the final closing of the private fund.

10 Section 20.6.2 of the ILPA Model Limited Partnership Agreement reads in relevant part: “the General Partner, without the approval of any Limited Partner or any other Person, may in its reasonable and good faith discretion enter into a side letter or similar agreement to or with one or more Partners (other than Affiliated Partners), executed in connection with the admission of such Partner to the Fund which has the effect of establishing rights under, altering or supplementing the terms of, or confirming the interpretation of this Agreement and the relevant Subscription Agreements with respect to such Partner(s) in order to meet certain requirements of such Partner(s) (each such side letter or agreement, a “Side Letter”), provided that the General Partner shall provide notice to each Limited Partner of the terms of all Side Letters reasonably promptly following the Final Closing Date and, if any such Side Letter grants more favorable rights to any Partner than those provided to another Partner, each such other Partner shall have the benefit of the more favorable rights, except (a) any rights granted solely with respect to a particular regulatory, legal or tax situation or policy (including any internal policy of a Partner that has been disclosed to the General Partner in writing at or prior to the date of such Partner’s subscription to the Fund) applicable to a Partner but not applicable to such other Partner, (b) any consent to, or limitation of the General Partner’s discretion with respect to, Transfers in favor of Affiliates of the recipient of such Side Letter, (c) any excuse rights granted pursuant to Section 6.7 (Excused Limited Partners) and (d) any right to nominate a representative on the Advisory Committee.”
years. In exchange for this commitment, they typically receive liberal withdrawal rights after the initial lock-up period as well as early withdrawal triggers based on a variety of contingencies which may include performance metrics. Since these arrangements are entered into prior to the launch of a new fund, it will be impossible to know in advance whether the seeder’s withdrawal rights could have an adverse effect on other investors at the future date when the withdrawal rights become operative. Under the circumstances, it may be impossible for seed capital providers to know whether their negotiated redemption arrangements are enforceable. This uncertainty is likely to have a substantial chilling effect on the willingness of seed capital providers to facilitate the launch of new funds by emerging managers.

Finally, in the rare case that the adviser enters into an arrangement that would provide preferential redemption rights which the adviser reasonably expects could have a material negative effect on other investors in the fund, the proposed rule should be modified to permit such activity, so long as the adviser puts such investors on an equal footing as the investor receiving the arrangement. For example, if the redemption right is subject to the adviser’s or fund’s ability to suspend all redemptions, then there is still an ability to treat all investors the same, which should be permissible. Similarly, if the adviser has the ability to extend the same redemption right to all other investors should the adviser determine, at the time the redemption right is exercised, that the redemption right could harm other investors, then there is still an ability to treat all investors the same, which should be permissible. Rather than banning a practice which has been in use for decades and which has benefited both investors and advisers, the SEC should in our view rewrite the rule to clarify that the ability to procure an equal outcome for all investors means a given redemption right is permissible. As to whether the adviser or fund actually procures such equal treatment at the time the redemption right is triggered, the SEC already has the means, through examinations and enforcement actions, to police the exercise of that discretion.

C. The SEC should not adopt Proposed Rule 211(h)(1)-2(c): Private fund quarterly statements — Portfolio investment table.11

The proposed quarterly statement rule would require advisers to disclose certain information with respect to any “covered portfolio investment” in a single table covering all covered portfolio investments. Specifically, the proposed rule would require a detailed accounting of all “portfolio investment compensation” allocated or paid to the investment adviser or its “related persons” by each covered portfolio investment during the reporting period and the private fund’s “ownership percentage” of each covered portfolio investment as of the end of the reporting period.

While private fund advisers are committed to transparency and to fully and accurately disclosing and/or mitigating conflicts of interest, we believe that if the proposed rules are

11 For purposes of this Section III.C, the “proposed rule” refers to § 275.211(h)(1)-2(c) and the relevant definitions in § 275.211(h)(1)-1.
adopted, the final rule should also take into account the SEC’s stated mission to maintain fair, orderly, and efficient markets and to facilitate capital formation. In that regard, mandatory investment-level reporting should be limited so that it does not unduly impede competition or the efficient allocation of capital in the private markets. We believe that the SEC’s policy objectives of protecting investors and increasing transparency could be achieved with a narrower set of rules.

In this section, we recommend a number of modifications to the proposed rule that would narrow its scope and reduce administrative and compliance burdens on advisers while still encouraging transparency in investment-level reporting. We provide these modifications as recommendations to the extent the SEC adopts a final rule. To be clear, we do not support, and we do not urge, the SEC to adopt any final rule, and believe such a rule to be unnecessary and inappropriate.

First, we recommend that portfolio investment compensation be subject to disclosure only where the adviser controls the portfolio investment’s decision to compensate the adviser or its related persons or otherwise cannot mitigate potential conflicts of interest. Second, we recommend that the proposed rule be revised to include exceptions for funds-of-funds and similar pooled investment vehicles that invest indirectly through unaffiliated structures in a large number of portfolio investments. Third, we propose additional limitations and clarifications that we believe should be included in the final rule and the Adopting Release. Fourth, we argue that the proposed rule, if adopted, would substantially increase costs and reduce competition in the industry, ultimately harming investors. Finally, we respond to certain questions posed by the SEC in the Proposing Release.

1. **Limiting Disclosure of Portfolio Investment Compensation to Situations that Pose Significant Conflicts of Interest**

We agree with the SEC that investors would benefit from greater transparency into compensation paid to the adviser by private fund portfolio investments, and we support a more standardized approach to disclosure of those compensation arrangements across the industry. However, we believe there are better, narrower ways that the proposed rule to address perceived conflicts of interest and foster greater transparency. If the final rule is to be workable, it should be limited to situations that actually pose conflicts of interest and should acknowledge that portfolio investments often do not share sensitive compensation information with non-controlling shareholders. The SEC should consider the organizational structure of many private fund sponsors and the administrative burdens (or, in some cases, actual impossibility) of obtaining the information required to be disclosed by the proposed rule and weigh those legitimate concerns against the potential benefit for investors.

In that regard, we believe that the definition of “covered portfolio investment” should be limited to require disclosure of “portfolio investment compensation” only where the adviser has discretion or substantial influence to cause the covered portfolio investment to compensate the adviser or its related persons. Portfolio companies typically choose among various competing
service providers based on a number of relevant factors, including experience and expertise (especially within a particular industry), competitive fees, sophistication, responsiveness, and quality of services. Where the adviser has no control or substantial influence over this selection process, or if the adviser delegates the decision to third-party company management or otherwise recuses itself from the process, then the conflict either does not exist or has been effectively mitigated.

In addition, many advisers are limited in the level of information they can accurately obtain from portfolio investments, especially given the broad definitions of “covered portfolio investment” and “related person.” Obtaining such information is often practically impossible where the adviser does not control the relevant portfolio investment. By contrast, an adviser with control can easily obtain such information, for example where the adviser has a board seat and can review and approve fees or other compensation (e.g., transaction fees, structuring fees, servicing fees) paid to the adviser or its related persons by the portfolio investment. The final rule should account for this important distinction.

Imagine, for example, a large financial institution that includes both a private fund adviser and a capital markets business, where a private fund managed by the adviser owns a passive 15% stake in a covered portfolio investment but has no management or other control rights. The third-party managers or directors of the portfolio investment might determine to engage the adviser’s affiliate to underwrite a securities offering by such portfolio investment and compensate the syndicate of underwriters, including as part of the syndicate, the affiliate-underwriter at market rates. The proposed rule would require the adviser to disclose the underwriting arrangement to its private fund investors even though the adviser might not even be aware of the arrangement, much less the details of the compensation paid to its affiliate-underwriter.

Moreover, large advisers with separate affiliated businesses may not have — indeed, often do not have — knowledge or access to information from their affiliates, either because of formal information barriers or because of other contractual or compliance restrictions. For example, financial institutions often cannot share information about their clients with other persons, including their affiliates, except on a need-to-know basis. Also, they are often subject to confidentiality obligations that would prevent the underwriter in the example above from sharing information about a company for which it performs underwriting services with the adviser whose fund invests passively in that company. Thus, unless the adviser or the private fund controls the company, the adviser will not be able to obtain information either from the company or from the adviser’s affiliate that has been engaged to provide services to that company, making compliance with the proposed rule highly impracticable if not impossible.

12 We acknowledge that legal, compliance or other control functions likely would have knowledge or access, but because of internal policies would not share such information with adviser personnel and certainly not with third-party investors.
Even if the adviser could access the portfolio investment compensation information in the above scenarios, it seems inappropriate and unfair to require disclosure of compensation paid by a portfolio company to hundreds or thousands of limited partners, many of whom are subject to FOIA and other public disclosure laws. The proposed rule, if adopted, might cause portfolio companies to decline such private fund investments in an effort to avoid such public disclosures of competitively sensitive information (e.g., what a company pays its service providers). This would increase the cost of capital for those companies and reduce returns for private fund investors indirectly invested in such companies, including the pension funds that invest on behalf of pensioners across the country.

The disclosures required by the proposed rule could also give investors the impression that a particular adviser charges higher fees than its competitors when the opposite is true. This is the natural consequence of the proposed rule requiring disclosure of portfolio investment compensation paid to “related persons” of the adviser but not to third parties. Many advisers provide in-house services to private funds at cost or otherwise on terms more favorable than could be obtained from a third-party service provider. This benefits investors by lowering costs. However, if investors are not easily able to discern those cost savings in the reporting required of private funds, the investors will not be able to compare accurately the costs of investing with one adviser over another. Moreover, advisers will be incentivized to hire third-party service providers rather than provide cheaper in-house services, because compensation paid to third parties is not required to be disclosed in the portfolio investment table.

We recommend that if the SEC adopts a final rule, it define “covered portfolio investment” to include only portfolio investments over which the adviser has “discretion or substantial influence” to compensate the adviser or its related persons. For purposes of the foregoing definition, an adviser should be deemed not to have “discretion or substantial influence” if (a) the private fund in question, together with other private funds controlled by the adviser, owns less than 25% of the voting securities of the relevant portfolio investment, and (b) the adviser and its related persons represent less than a majority of the voting members of the board (or equivalent governing body) of such portfolio investment.

Even if the adviser has “discretion or substantial influence” as defined above, we believe that disclosure of portfolio investment compensation should not be required if the adviser has delegated the selection and compensation decisions to third-party company management or is subject to written policies and procedures requiring it and its related persons to recuse themselves from decisions relating to the selection and compensation of such persons by covered portfolio investments. If the adviser has delegated its decision-making authority or recuses itself from selection and compensation decisions that it would otherwise control, then the conflict of interest has been effectively mitigated if not eliminated. With respect to recusal, such “written policies and procedures” could require, for example, that if a covered portfolio investment presents to the adviser (in its capacity as director/manager or controlling shareholder) the question of whether to hire or compensate one of the adviser’s related persons, the adviser could recuse itself from the question and thereby avoid application of the portfolio investment-level
disclosure rule. If the adviser has not delegated its decision-making authority or otherwise recused itself, the adviser could then be required to disclose the portfolio investment compensation to the extent permitted by law and subject to the private fund investors agreeing to a non-disclosure agreement. To further protect sensitive competitive information at the portfolio investment level, the final rule should allow advisers to aggregate and anonymize non-recused fees. Aggregate, anonymized information would provide the same benefit to investors while protecting confidentiality and sensitive competition information of both the portfolio investment and the adviser’s related persons.

To be clear, we are not arguing for elimination of the portfolio investment table. We are simply suggesting that the SEC could achieve the same policy objectives with a more narrowly tailored rule.

2. Limiting Disclosure Requirements for Funds-of-Funds

We believe that the definition of “covered portfolio investment” should expressly exclude direct and indirect investments held by unaffiliated pooled investment vehicles into which a private fund invests. As the Proposing Release seems to acknowledge, funds-of-funds are often indirectly invested in hundreds or thousands of portfolio companies. Such funds often do not have access to underlying portfolio company information; even if they had access, the cost and time required to collate such information would be prohibitive and investors would likely be overwhelmed by the amount of such information. For example, the proposed rule would require a fund-of-funds to disclose not only the funds into which it makes direct investments but also the hundreds or thousands of intermediary structuring entities and “real” companies in which the fund-of-funds is indirectly invested — and, in each case, any compensation paid by any such entity to the adviser or its related persons. Even if it were possible to collect and summarize this data, no ordinary fund-of-funds investor would desire it or be able to process it efficiently — and likely would not wish to bear the costs that the fund-of-funds would incur to comply with this part of the proposed rule.

Even if the SEC were to reject this argument, it should, at the very least, adopt special reporting rules for funds-of-funds. We believe funds-of-funds should be able to satisfy the requirement to deliver quarterly statements by forwarding the quarterly statements received from underlying fund managers or, if funds-of-funds advisers choose to prepare their own statements, there should be additional time to deliver the statements (like in the case of delivering audited financial statements to comply with the Custody Rule). Requiring covered portfolio investment information to be provided within 45 days of the end of each quarter is impractical or impossible

13 This type of safe harbor exists elsewhere and has proved workable in similarly conflicted situations. For example, Section 144 of the Delaware General Corporation Law provides that certain self-interested transactions are not voidable solely due to a conflict of interest so long as certain conditions are complied with. Namely, the conflicted transaction must be (i) approved by a majority of fully informed disinterested directors, (ii) approved in good faith by a vote of fully informed stockholders, or (iii) “fair as to the corporation” at the time it is approved by the board of directors, a committee of the board, or the stockholders.
for many funds-of-funds, and the information provided in such reporting is likely to be duplicative. Portfolio-investment level information is often included in annual fund-level reporting; requiring separate quarterly reporting of the same information would be unnecessarily costly and of limited benefit to investors. If quarterly disclosures are required, the 45-day period should be extended. Funds-of-funds and other funds with large numbers of underlying investments require more time to prepare the detailed accounting required by the proposed rule. Advisers should have discretion to go beyond 45 days as necessary in light of the character of the fund’s portfolio.

3. Further Limitations on the Scope of the Proposed Rule

If the proposed rule is adopted, it should be further limited in a manner that protects the legitimate interests of advisers and their related persons while still advancing the SEC’s legitimate policy objectives.

i. Offsets, Rebates, Waivers

As stated above, we believe that advisers should be required to disclose portfolio investment compensation only if they have “discretion or substantial influence” over the selection and compensation decisions. However, even if the SEC rejects the opportunity to eliminate or substantially narrow the proposed rule, we believe that advisers should only be required to disclose the amount of portfolio investment compensation (if any) after the application of any offsets, rebates, or waivers, rather than before and after. Any conflicts of interest are mitigated or eliminated where portfolio investment compensation is fully offset against fund-level compensation; the adviser has less of an incentive to seek higher fees from portfolio companies where such fees are credited to the fund (and therefore the investors). The Proposing Release asserts that disclosing portfolio investment compensation both before and after the application of any offsets, rebates, or waivers would meaningfully increase transparency and “would assist investors in monitoring their private fund investments and, for certain investors, would ease their own efforts at complying with their reporting obligations.” We respectfully disagree. We believe that disclosing detailed accounting of portfolio investment compensation not actually borne by investors would be of limited or no value to those investors.

ii. Top-Line Reporting

We believe that advisers should be required to disclose only the total portfolio investment compensation borne indirectly by the fund for the reporting period as an aggregate number, rather than providing the amount of compensation allocated or paid by each covered portfolio investment as proposed. Disclosing a consolidated “top-line” number that covers all covered portfolio investments would lower costs and compliance burdens on the adviser and result in clearer, more meaningful disclosure for investors. Private fund investors currently receive a large volume of information from advisers, and it is difficult in practice for investors to evaluate the data they receive in connection with their private fund investments, especially for institutional investors that are invested in dozens or hundreds of alternative investment products.
Allowing advisers to disclose consolidated, “top-line” figures is a simple, effective way to reduce compliance burdens on investors and advisers without sacrificing transparency. Advisers, investors, and regulators all have an interest in more efficient information sharing.

**iii. Confirmation that Duplicative Reporting is not Required**

As a clarification, we believe that the definition of “portfolio investment compensation” should expressly exclude fund-level fees and other compensation paid by a subsidiary of the fund in accordance with the fund’s governing documents. Private fund documents often permit management fees and incentive compensation to be paid or allocated by a subsidiary of the fund rather than by the fund itself; these amounts should be treated as fund-level compensation, not investment-level compensation. Otherwise, fees will be reported more than once, creating confusion and the appearance that fees are higher than the amount actually borne by investors. The proposed rule seems to require duplicative disclosure.

**iv. Limiting Definition of Ownership Interest**

We believe that the final rule should require advisers to list the fund’s ownership percentage of a covered portfolio investment only if (i) the adviser has discretion or substantial influence (as defined above) over whether to cause such covered portfolio investment to cooperate with the preparation of that information and (ii) such covered portfolio investment is the ultimate underlying investment held by the fund (in other words, intermediary special purpose vehicles (SPVs) should be excluded). As stated above, where the adviser lacks control, it might be overly difficult or impossible for the adviser to obtain accurate ownership information. Requiring advisers to disclose ownership information for every SPV or holding company in complex structures would not provide meaningful information to investors and would only create confusion. Investors are not interested in their ownership percentages of each intermediary SPV in each investment structure. Advisers should be permitted to determine in good faith what constitutes the “ultimate” investment or company and disclose only that single, look-through ownership percentage.

**v. Discretion to Withhold Information**

Even if the SEC does not adopt the modifications to the proposed rule suggested above, it should still consider granting advisers the option to withhold portfolio investment-level information in certain limited, well-defined circumstances, as described below. The proposed rule, if adopted, would likely create many unintended collateral consequences not only for advisers but other parties not intended to be impacted by the rule. Those consequences could be mitigated by allowing advisers to exercise their commercial judgment in certain sensitive situations.

First, advisers should be permitted to withhold covered portfolio investment information if such information would be disclosed to investors that are subject to FOIA or other similar public disclosure laws. Limiting disclosure in this manner is a common feature of private funds.
For example, private fund operating agreements usually allow fund sponsors to withhold information that might be the subject of public disclosure, and these provisions are not controversial in the market in our experience. It is well established in the industry that private funds have an interest in limiting public disclosures if possible under applicable law. The final rule should not overrule this well-established market practice by imposing a one-size-fits-all approach that essentially mandates public disclosure of sensitive portfolio investment information.

Second, advisers should be permitted to withhold covered portfolio investment information if such information contains proprietary or competitive information relating to the business of the adviser, its related persons, or the portfolio investment. This information is protected under many state public disclosure laws and should be treated the same way under federal law. The proposed rule, if adopted, would create the incongruous result of mandating disclosure by private funds to state pension plans of information that those plans are legally prevented from disclosing to the public. Even if portfolio investment information were not disclosed by investors pursuant to state sunshine laws, the proposed rule, if adopted, would reveal sensitive competitive information that could impair future transactions.

Third, advisers should be permitted to withhold covered portfolio investment information where the disclosure of such information would cause the adviser, its related persons, or the private fund to violate applicable law or breach a confidentiality obligation or other written agreement. Without such exceptions, advisers would constantly be forced to choose between violating Advisers Act rules, on the one hand, or other applicable law or contractual terms, on the other hand. For example, a private fund might sign a non-disclosure agreement (NDA) with a portfolio company during an early funding round that restricts it from disclosing its investment in the company. If that company hires a related person of the adviser in connection with a potential IPO, the adviser would have to decide whether to breach the NDA by disclosing the portfolio investment compensation or violate SEC rules by withholding such information.

Fourth, advisers should be permitted to withhold covered portfolio investment information if gathering such information would require the adviser, its related persons or the fund to breach internal compliance policies (including by crossing an internal “firewall” or receiving or disclosing material non-public information (MNPI) to another party (including a related person of the adviser)). Similarly, we do not believe it would be fair or consistent with the SEC’s goals to adopt a rule that effectively requires advisers to breach their own internal policies, including those aimed at protecting MNPI.

Finally, we agree with the implication of a question in the Proposing Release that advisers should be permitted to withhold portfolio investment compensation if the adviser

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14 For example, the Maryland Public Information Act prevents the disclosure of “trade secrets, confidential commercial or financial information, and confidential geological or geophysical information, if that information is furnished by or obtained from any person or governmental unit.” See Maryland Public Information Act Manual (16th ed., Sept. 2021), at 3-23–24.
determines in good faith that such compensation is *de minimis* and therefore would not materially alter the total mix of information otherwise available to investors. Advisers have long been permitted to make judgments as to materiality (e.g., when deciding what terms to disclose in a private offering memorandum), and there is no reason to believe they are not capable of making similar judgments here.

4. **Increased Costs, Less Competition and Too Much Unnecessary Information**

We believe that the proposed rule would impose substantial, unjustified additional costs on private funds and their advisers, which would ultimately be borne by, and harm, fund investors. In addition, as we observed above, the benefit to investors would be limited due to, if nothing else, the overwhelming amount of information required to be disclosed. If investors do not have the resources or inclination to process large volumes of information from private funds, the costs of producing such information does not seem justified.

In the case of smaller advisers, we believe that the proposed rule would impose unnecessary costs, harm their ability to compete, and create additional barriers to enter the investment industry. For smaller advisers, the compliance costs associated with the proposed rule are expected to be prohibitive, resulting in further consolidation and less competition in the industry. The Proposing Release acknowledges that standardization and comparability of information could adversely impact compensation and make smaller advisers less competitive as employers. This could potentially cause many advisers to terminate their businesses and would also create additional barriers to entry for new, small advisers. Decreased competition in turn ultimately harms the investment community and the ultimate investors, including pension plans and their investors, and also deprives portfolio companies of important capital.

The Proposing Release estimates, optimistically, that the total annual burden per adviser to comply with this new disclosure obligation would be approximately $85,000 per adviser. We believe that, in reality, compliance costs for most advisers will be much higher.

5. **Responses to Certain Questions in the Proposing Release**

We wish to address certain questions in the Proposing Release asking whether the proposed rule should be further expanded.

i. **Derivative Transactions**

We agree with the SEC that, to the extent a private fund enters into a negotiated instrument, such as a derivative, with a counterparty, the private fund should not be considered to have made an investment in the counterparty. Derivative contracts, for example, are not investments by the private fund but rather the result of an arm’s-length negotiation for a specific service. The same concerns regarding transparency and conflicts of interest do not apply. Subjecting such contracts to the proposed rule would greatly expand its scope, and the volume of information required to be disclosed and digested, without providing meaningful investor protections.
ii. Allocation of Portfolio Investment Compensation Among Multiple Private Funds

We believe that the proposed rule should not be revised to require advisers to disclose how they allocate or apportion portfolio investment compensation among multiple private funds invested in the same covered portfolio investment. The governing documents of private funds often include rules regarding the allocation of portfolio investment compensation among various clients of the adviser. These provisions are negotiated by investors, and in any case provide clear allocation rules that the adviser is required to comply with. Requiring further disclosure would simply increase the amount of information investors must analyze without providing meaningful incremental protections.

iii. Portfolio Investment Compensation Paid to Other Persons

We believe that the proposed rule should not be revised to require disclosure of portfolio investment compensation paid to other persons (such as co-investors, joint venture partners, and other third parties), even if such compensation reduces the value of the private fund’s interest in the portfolio investment. For the reasons stated above, advisers are often not in a position to obtain detailed information regarding payments made by portfolio investments in which their funds invest. And even where they are in such a position, the time, capital, and other resources required to gather and collate such information does not seem justified by any incremental benefit that might accrue to investors. Finally, and most important, portfolio investment compensation paid to persons not affiliated with the adviser does not pose conflicts of interest and therefore is properly outside the scope of the proposed rule.

D. The SEC should not adopt Proposed Rule 211(h)(1)-2(e): Private fund quarterly statements — Performance.\(^\text{15}\)

Requiring quarterly performance reporting is an overbroad solution where there is no meaningful problem because private fund investors often negotiate specific periodic performance reporting and private fund advisers often accommodate such requests. Further, the content of performance information is already subject to regulation under the federal securities laws, including rule 206(4)-8 of the Advisers Act, which require that it not be misleading. Advisers cannot use any form of performance presentation that would violate those rules. Private fund investors are protected by existing laws, and the proposed rule simply reflects a value judgement in favor of one particular format of presentation. There is no “one size fits all” approach that every private fund investor agrees upon. Different private fund investors have different views as to what information, if any, would best help them analyze the private fund adviser’s performance. The proposed rule treats private fund investors as unsophisticated retail investors that require the SEC to prescribe the form of information they should receive. Private fund investors are equipped to determine what information is most relevant and helpful, and if an

\(^{15}\) For purposes of this Section III.D, the “proposed rule” refers to § 275.211(h)(1)-2(e) and the relevant definitions in § 275.211(h)(1)-1.
investor is not satisfied with the type or extent of performance information that the adviser is presenting, the investor may request alternative or supplemental information and, if not entirely satisfied, is under no obligation to invest.

While we understand the SEC’s policy goal of providing comparable performance to private fund investors, the SEC should recognize the wide range of investment products and structures that fit within the broad definition of “private fund” will lead attempts at rigid standardization to confusing results for private fund investors, and there are more appropriate methods of regulation that would meet the SEC’s stated policy goal.

If quarterly performance reporting is mandated, the rule should preserve the flexibility for a private fund adviser to determine which performance metrics are the most appropriate to disclose to its investors to provide meaningful information. Dictating standard performance of private funds will result in meaningless (and potentially confusing) metrics to investors because the standardization over-simplifies and fails in its attempt to standardize the myriad various types of strategies operating within the private fund structure. For example, the proposed rule prescribes different performance metrics for “liquid” and “illiquid” funds under the assumption that all private funds would only meet one of those categories and that all private funds within each category would calculate their performance with the same metrics. However, the universe of private funds cannot be split between liquid and illiquid funds as defined. In particular, the distinction between liquid and illiquid funds is overly technical and does not fit with the way sponsors market their private funds, particularly in the “predominant operating strategy” prong and the undefined “de minimis amount of liquid assets” requirements. The Proposing Release notes that there are private funds that would not fit into either category, but does not offer accommodation to deviate from the strict definition imposed. As a result, a certain private fund that would be more suited for reporting an IRR and MOIC will be required to provide total net returns, which will only serve to confuse investors. Even within the two categories of “liquid” and “illiquid” funds, the wide range of strategies employed by private funds that would fit either category is so broad that the dictated performance metrics required within the categories would not provide meaningful information to investors. For example, CLO funds that meet the definition of “illiquid fund” would be required to provide MOIC figures, which would be irrelevant and confusing to investors. As recently as the Marketing Rule adopting release in December 2020, the SEC noted that it would not prescribe any particular performance requirements because “prescribing the calculation could unduly limit the ability of advisers to present performance information that they believe would be most relevant and useful” given the variation among types of advisers and investments.

Instead of creating new, unworkable definitions of types of funds that dictate specific performance metrics, the SEC should permit private fund advisers to report performance metrics that they feel are most appropriate, including, for example, the performance metrics used when marketing their private funds and disclosing the criteria and assumption made when calculating such performance. It would be confusing to investors to receive total return numbers when the fund was marketed based on a track record calculating IRR. Similarly, if the SEC does not believe advisers should be permitted to choose the appropriate performance metrics, the SEC
should look to existing guidance to delineate between types of funds — for example, by defining illiquid funds as funds that do not issue “redeemable securities” under existing Investment Company Act guidance — instead of creating new definitions.

In addition, the requirement to disclose performance metrics without the use of subscription lines is sacrificing meaningful disclosure to private fund investors. A private fund adviser’s ability to efficiently use a subscription line is an important benefit for private fund investors because it allows investors to manage their own liquidity and maximize the returns of their capital by deploying it in other investments (as opposed to immediately providing such capital to the fund). Performance that incorporates the use of a subscription line reflects the actual experience of private fund investors, as it is based on the dates that capital is called from investors rather than the (generally earlier) dates on which the subscription line was drawn; as a result, performance metrics without the effect of a subscription line will not align with investor experience and have the potential to confuse investors. While subscription lines are generally limited in time and scope, a private fund adviser that uses them appropriately can increase an investor’s return by a magnitude of basis points, which is an actual benefit to the investor. The interest charged on the subscription line is already factored into returns, and it is an expense that reduces the incentive compensation the private fund adviser receives. A private fund adviser’s ability to manage subscription lines deftly should be taken into account when investors are comparing private funds against each other, because this acumen also benefits investors. In addition, if the proposed rule were adopted, private funds, which are exempted from registration as an investment companies, would be subject to performance reporting obligations that do not even apply to registered investment companies or business development companies, which are not required to separately calculate hypothetical performance excluding leverage. Accordingly, any final rule should permit the disclosure of performance metrics that do take into account the use of a subscription line.

The Proposing Release also notes that providing granular breakdowns of gross IRR and MOIC for the realized portion and the unrealized portion of an illiquid fund would assist investors in determining whether performance measures are overly optimistic. However, providing additional breakdowns of realized vs unrealized would actually have no effect on this understanding, which is really about the effectiveness of an adviser’s valuation policies with respect to unrealized investments.

We further note that each additional piece of information required to be provided to investors has the potential to confuse investors and care should be taken in dictating incremental data points. For example, if the gross IRR and MOIC information discussed immediately above is required to be presented to investors, these data points would be in addition to providing the net MOIC, the net IRR, the gross MOIC, and the gross IRR, all presented with and without the impact of a subscription line. Similarly, the proposed rule would require illiquid funds to provide a statement of contributions and distributions to allow investors to understand the fund’s performance holistically. However, the Proposing Release acknowledges that such statements are not currently provided to private fund investors. Again, private fund investors are able to choose and negotiate the types of information that they deem important to their monitoring.
efforts. As highlighted by the Proposing Release, the level of rigid granularity required by the proposed rule is not commonly sought by private fund investors. Therefore the SEC should not require private fund advisers to provide that information when it will likely result in confusion for investors. Additionally, requiring liquid funds to report the one-, five-, and ten- calendar year periods will provide data to investors that the SEC recently determined in the Marketing Rule was not useful information for private funds. Requiring the use of standardized reporting information to be presented alongside the more relevant data will result in multiple sets of performance data and metrics, creating additional confusion for investors and an overwhelming volume of information that will be difficult if not impossible to digest.

Finally, imposing additional, arbitrary reporting requirements on private fund advisers under the purported goal of “standardization” will impose administrative and monetary burdens on those advisers and their investors. The additional costs will either be borne by advisers — unfairly penalizing smaller managers, who are less well positioned to absorb such costs and burdens — or will be passed on to investors, increasing the expenses they bear. Because smaller advisers do not have the same large back-office resources as larger managers, this may impose additional hurdles to capital formation, particularly for emerging managers, who are often among the best sources of innovation in the market.

E. The SEC should not adopt Proposed Rule 211(h)(2)-2: Adviser-led secondaries.\(^{16}\)

The SEC’s focus on adviser-led secondaries in the current market is unnecessary given the institutionalization and evolution of these transactions over the years. While the SEC’s focus on these transactions early on in its tenure regulating private fund advisers after the Dodd-Frank Act appropriately focused on “zombie” funds that were suffering the collateral damage of the global financial crisis, the secondary market has evolved since then such that advisers and investors routinely negotiate the terms under which such transaction will be permitted. The SEC notes that advisers have increasingly become active in the secondary market, but that growth is due in part to investor demand for such transactions, as well as the fact that advisers and investors have established a well-known playbook on how such transactions are typically conducted.

Adviser-led secondary transactions are highly negotiated, bespoke transactions where a blanket requirement to obtain a fairness opinion would (a) serve little to no substantive purpose in many instances, (b) unnecessarily drive up costs for fund investors and (c) chill the market for small and mid-sized advisers. The determination of when a fairness opinion should be obtained

\(^{16}\) For purposes of this Section III.E, the “proposed rule” refers to § 275.211(h)(2)-2 and the relevant definitions in § 275.211(h)(1)-1.
for a transaction is best left to the participants in that transaction, who are properly positioned to make a cost/benefit analysis.

While a fairness opinion is useful for certain transactions, we do not believe that they provide meaningful benefits in all, or even a majority, of adviser-led transactions. For example, a fairness opinion would not be value-additive if the transaction were conducted at a price that is near, at, or above net asset value. Similarly, when a competitive sales process has been conducted for the secondary transaction or the relevant assets, or where the pricing of a deal has otherwise been validated by unaffiliated third parties, a fairness opinion would not provide much additional information beyond what is already available to the investors.

In situations where a fairness opinion could be useful (such as transactions involving distressed assets, transactions where the pricing is significantly below net asset value, or transactions involving illiquid assets that did not involve a competitive sales process), the adviser would remain bound by its fiduciary duties to both the divesting advisory client and the acquiring advisory client, including relevant Advisers Act requirements and SEC guidance pertaining to cross trades. The adviser may determine, in such instances, that it would be consistent with its fiduciary duties and Advisers Act obligations to obtain a fairness opinion. However, the adviser should have discretion to determine whether obtaining a fairness opinion is the best way to satisfy its duties and obligations to its clients based on the particular facts and circumstances of the transaction. Further, fairness opinions may not be available for certain esoteric assets, in which case it should be permissible for investors to determine the price at which they are willing to engage in the transaction instead of being prohibited from the option to make that investment decision.

Adviser-led secondary transactions also typically involve sophisticated, institutional investors that have the ability and experience to conduct in-depth due diligence, including with respect to valuation, and to negotiate the terms of the transaction with the adviser. Existing and prospective new investors simply may not see a need for a fairness opinion based on the facts and circumstances of the deal. Requiring advisers to obtain a fairness opinion in such circumstances could actually be a counterproductive use of their time and resources.

Moreover, existing market practices around adviser-led secondary transactions already provide significant investor protections that obviate the need for a fairness opinion. For example, adviser-led transactions typically require the consent of the fund investors or a representative board in order to proceed, and such investors will consider the terms of the proposed transaction in determining whether to give approval. In addition, investors typically have the option either to obtain liquidity or to “roll” all or a portion of their interests into the acquiring vehicle. As such, investors in the divesting entity can usually “vote with their feet” on the terms of any transaction that is presented to them. Furthermore, as discussed above, adviser-led secondary transactions often involve a competitive sales process that canvasses the market for potential buyers and provides market validation for the price at which the transaction is ultimately consummated.
In addition, the cost of obtaining a fairness opinion is meaningful and such costs will be borne by the advisory client and passed down to the underlying investors. A blanket requirement to obtain a fairness opinion would place an added burden on the fund’s investors without necessarily offering commensurate benefits. This requirement will have a disproportionate impact on smaller advisers and smaller funds, as well as on situations in which the secondary transaction is being used to create liquidity in a small amount of residual assets remaining after the bulk of a fund's assets have been resolved. Indeed, the prospect of needing to obtain a fairness opinion may dissuade some advisers from pursuing an adviser-led secondary transaction in the first place despite such a transaction being potentially beneficial to the fund and the underlying investors. The adviser may also be incentivized to liquidate fund assets in sales to third parties rather than giving investors the flexibility, through secondary transactions, to individually decide whether to opt for liquidity today or for a potentially higher price at a later time. In light of such cost considerations, we believe that the adviser — and the limited partner advisory committee or limited partners that have the power to approve the transaction — should have discretion, and are best positioned, to determine, based on the facts and circumstances of a transaction, whether a fairness opinion would provide sufficient benefits to outweigh its cost.

We also believe that requiring advisers to provide a summary of material business relationships with the fairness opinion provider would be duplicative of pre-existing obligations to which the advisers are bound. Advisers are already subject to a fiduciary duty to disclose any material conflicts to their investors. Any material relationships with fairness opinion providers that give rise to material conflicts of interest would fall within the scope of such disclosure obligations and related information would be made available to the existing and prospective new investors.17

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17 In its separate proposal to amend the Form PF, the SEC has put forward a one-business day reporting requirement for adviser-led secondary transactions. See SEC, Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, Rel. No. IA-5950 (Jan. 26, 2022). We believe that such requirement would also impose a significant administrative burden on advisers without serving a clear purpose. The SEC’s proposal indicates that part of the intent is to monitor transactions of this type as they could indicate an inability to sell portfolio companies through more traditional exit avenues or a declining market. However, in our experience, the choice to pursue an adviser-led secondary transaction is no longer a good indicator — or any indicator at all — that the assets being sold in such transaction cannot be sold through more traditional means, or that the broader financial market is declining. Indeed, the past few years, which have seen a marked increase in the frequency of adviser-led secondary transactions, have also been accompanied by an unprecedented bull market. Adviser-led secondary transactions should be viewed as they are by the market — as simply another tool in the private fund adviser’s toolbox when considering liquidity solutions and exit opportunities that maximize value on behalf of private fund investors. If the SEC wants aggregate data on adviser-led secondary transactions, that data would be better collected in ways other than reporting every adviser-led transaction by all private fund advisers within one business days after its completion. For example, an annual report summarizing such transactions for certain large advisers would be much less burdensome, much less likely to result in “foot-faults” by smaller, more leanly resourced advisers, and much more likely to provide the SEC staff with useful information. As with the other events for which the proposed Form PF amendment requires one-day reporting, we believe that immediate reporting of adviser-led secondary transactions would be unduly burdensome,
F. The SEC should not adopt Proposed Rule 206(4)-10: Private fund adviser audits.¹⁸

The overwhelming market practice for private funds is to obtain audits of investment vehicles, reflecting the fact that current rules and market dynamics work — there is no market problem to be solved by the proposed rule. Private funds that do not obtain audits are uncommon and where audits are not obtained there are specific rationales. For example, advisers that have been in operation for many years and determine to register (i.e., advisers relying on the venture capital fund exemption in rule 203(l)-1 of the Advisers Act) may have funds that have been in operation for over a decade for which their investors did not require an annual audit in the funds’ original governing documents that will find it cost prohibitive and, in certain cases, operationally impossible, to generate the necessary work papers required by auditors dating back to the inception of the fund to enable the auditor to issue an audit consistent with GAAP today.

In addition, the Advisers Act custody rule already achieves the policy objectives underlying the proposed rule, making the proposed unnecessary. Overlapping and inconsistent standards do not serve any part of the SEC’s statutory mission, including investor protection. Overlapping and inconsistent standards also cause confusion and the potential for inadvertent foot faults by investment advisers.

Further, as discussed further below, the scope of this proposed rule would apply to all registered advisers without any exception for non-US advisers and their relationships to non-US funds. This application would in effect (without discussion or analysis) reverse the SEC’s long-standing position with respect to non-US clients of non-US advisers which has expressly stated that the custody rule should not apply to such clients.

G. The SEC should narrow the scope of the proposed rules, and in particular the proposed rules should not apply to non-U.S. private funds managed by non-U.S. advisers.

The proposed rules implementing prohibitions on certain activities and regarding preferential treatment are intended to apply to all advisers, whether registered with the SEC or not, including state-registered advisers, exempt reporting advisers, and foreign private advisers. Applying such onerous substantive rules to advisers that have not been required to register with the SEC is inappropriate because the SEC has already determined that it is not in the public interest to require such advisers to be subject to the most of the substantive provisions of the Advisers Act.

¹⁸ For purposes of this Section III.F, the “proposed rule” refers to § 275.206(4)-10.
In addition, the SEC confirmed in the Proposing Release that “the proposed prohibited activities rule would not apply to a registered offshore adviser’s private funds organized outside of the United States, regardless of whether the private funds have U.S. investors” and asked whether “other rules in this rulemaking package take the same approach, or a different approach, with respect to a registered offshore adviser’s offshore private fund clients.”

We do not believe any version of the proposed rules should be adopted; however, if the SEC seeks to adopt final rules, it should at the very least clarify that none of the rules (not just the prohibited activities rule) applies to for non-U.S. advisers with respect to their non-U.S. funds. Without this exclusion, the proposed rules run counter to the decades-long SEC position establishing that the substantive provisions of the Advisers Act do not apply to non-U.S. advisers with respect to non-U.S. clients. It is inappropriate for the SEC to change such a long-standing position without any legal analysis or evaluation in the Proposing Release. If the SEC is in fact re-evaluating this position, it should do so expressly, explain why it is doing so, provide an economic analysis of the impact, and allow sufficient time for public review and comment.

**H. The SEC should narrow the definition of “private fund.”**

The definition of “private fund” in the proposed rules is overly broad. For example, collateralized loan obligations (“CLOs”) and similar credit securitization products represent a market of over a trillion dollars. CLOs typically rely on the Section 3(c)(7) exclusion and thus would be considered “private funds.” The failure either to exempt securitization products or to articulate any rationale for the inclusion of this distinct asset class in the scope of the proposed rules (or even to mention this effect of the proposed rules) is a serious oversight that must be addressed.

In addition, the SEC should carve out “funds of one.” The proposed rules plainly and appropriately do not apply to investment management agreements between an alternative investment manager and an institutional investor that is not itself a private fund. However, these individually negotiated arrangements are often structured as special purpose “funds of one” in order to address tax, regulatory, limited liability or other goals of the investor. This is a meaningless distinction which may impair the ability of investors to achieve optimal results.

**IV. Statutory Authority**

We do not believe section 211(h) of the Advisers Act grants the SEC authority to adopt rules for private fund advisers.

The SEC provides no analysis of its authority to adopt the “Rule 211” series of proposed rules, and instead merely asserts that it is proposing rules under the authority provided by sections 206(4) and 211(h) of the Advisers Act. The lack of such analysis deprives us and other commenters of the opportunity to provide meaningful comment in response to the SEC’s understanding of its authority.
To the extent the SEC interprets Section 211(h) in isolation from the rest of Section 211, all of which addresses circumstances in which broker-dealers and investment advisers provide advice to retail investors, we believe that the SEC misreads that section. Moreover, the SEC appears to ignore the legislative intent leading to enactment of Section 211 of the Advisers Act and is asserting authority in a context that Congress did not intend. Section 211(h) was added to the Advisers Act by Section 913(g) of the Dodd-Frank Act, which section is entitled “Authority to Establish a Fiduciary Duty for Brokers and Dealers.” While section titles are not binding interpretations, they represent a clear expression of Congressional intent that the authority provided under Section 211(h) was intended to address actions the SEC could take to better align the conduct standards of broker-dealers and investment advisers when providing similar services.

The clear Congressional mandate under Section 913(g) of the Dodd-Frank Act was to enhance conduct standards and disclosures for retail investors, not for institutional and other sophisticated investors that invest in private funds. Private fund advisers are not referenced or contemplated in Section 913(g) of the Dodd-Frank Act. Should the SEC seek to interpret Section 211(h) in such a novel and broad manner that is not contemplated by the Congressional record, we believe that the SEC would risk a definitive court decision severely limiting that authority in other circumstances. To the extent the SEC interprets Section 211(h) in isolation from the rest of Section 211, all of which addresses circumstances in which broker-dealers and investment advisers provide advice to retail investors, the SEC clearly misreads that section and Congressional intent.

The SEC also appears to be relying on rulemaking authority under Section 206(4) of the Advisers Act for certain portions of the proposal, though the SEC does not clearly identify which parts of the proposed rules it believes it is proposing under that authority. Regardless, we do not believe that the extent of the SEC’s rulemaking authority under Section 206(4) of the Advisers Act has been subject to interpretation in a court proceeding. To the extent any final rule is successfully challenged on the basis that it exceeds the SEC’s authority, the court’s decision could impose significant limitations on the SEC’s ability to enforce rules already adopted under Section 206(4) or to adopt future rules, or amend existing ones, in reliance on that authority.

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The undersigned law firms would greatly appreciate the opportunity to meet with the SEC Staff to discuss any questions regarding our comments on the proposed rules, and we will reach out directly to schedule a meeting.

The Private Investment Funds Forum

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

Akin Gump Strauss Hauer & Feld LLP
Cleary Gottlieb Steen & Hamilton LLP
Davis Polk & Wardwell LLP
Debevoise & Plimpton LLP
Fried, Frank, Harris, Shriver & Jacobson LLP
Gibson, Dunn & Crutcher LLP
Goodwin Procter LLP
Kirkland & Ellis LLP
Paul, Weiss, Rifkind, Wharton & Garrison LLP
Ropes & Gray LLP
Schulte Roth & Zabel LLP
Simpson Thacher & Bartlett LLP
Skadden, Arps, Slate, Meagher & Flom LLP
Weil, Gotshal & Manges LLP
Willkie Farr & Gallagher LLP