Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York

April 25, 2022

Via Electronic Submission

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

Re: Proposed Rule on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (RIN: 3235-AN07; Release No. IA-5955; File No. S7-03-22)

Dear Ms. Countryman:

Managed Funds Association[1] ("**MFA**") welcomes the opportunity to comment on the Securities and Exchange Commission's ("**Commission**" or "**SEC**") proposed rules "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews" ("**Proposed Rules**").[2]

MFA has long advocated for thoughtful regulatory oversight of private fund advisers and recognizes the importance of well-crafted rules that help govern the activities of private fund advisers with respect to their fund clients and fund investors. Private funds play an essential role in the portfolios of institutional investors—including pensions, foundations, and endowments—located in all 50 states. Private funds help them deliver reliable returns in support of their beneficiaries. These institutional investors help provide retirement security to more than 26 million retired teachers, firefighters, police officers, and other public employees. Investment with MFA members help support the mission driven work of 1,000 nonprofits and foundations nationwide. More than 300 educational institutions invest in private funds to provide scholarships and fund academic research. `

[1] MFA represents the global alternative investment industry and its investors by advocating for sound industry practices, regulatory, tax and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 member firms collectively mange nearly $1.6 trillion across a diverse group of investment strategies. MFA is an advocacy, education, and communications organization established to enable investment advisers in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA has a global presence and is active in Washington, D.C., London, Brussels, and Asia.

[2] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16886 (Mar. 24, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf.

However, the Proposed Rules will fundamentally alter the fruitful, longstanding relationships between private funds and their sophisticated investors. An MFA-commissioned assessment of the Commission's economic analysis (discussed below) found that it did not make a sound case for the Proposed Rules and that it failed to fully consider the unintended costs associated with the proposals. Contrary to indications in the release accompanying the Proposed Rules ("**Release**") that the Proposed Rules may lower fees and increase competition,[3] we are concerned that in practice the Proposed Rules will have the opposite effect, much to the detriment of investors and the industry. Not only do the Proposed Rules fail to address the Commission's stated objectives, but they harm—rather than protect—investors in numerous ways and will significantly increase legal, regulatory, compliance, operational, and other costs, which will, among other things, create steep barriers to entry for new advisers, as well as lead to consolidation in the industry, thereby reducing competition and the investment choices available to investors. In turn, the Proposed Rules may impair the ability of investors to deliver for their beneficiaries, including retirees, students, and individuals who rely on charities.

Further, we believe the Proposed Rules have a number of fundamental flaws from the perspective of the Administrative Procedure Act ("**APA**") and plainly exceed the Commission's authority under the Investment Advisers Act of 1940 ("**Advisers Act**") and other applicable law. As explained further below, we believe the Proposed Rules fail to give adequate consideration to less costly alternatives and, consequently, will needlessly upset the carefully constructed commercial relationships that private fund advisers and their sophisticated investors have negotiated over many years.

I. Executive Summary

MFA respectfully urges the Commission to withdraw the Proposed Rules, which we believe have several fundamental flaws that raise significant concerns, both with respect to the Commission's authority and with respect to unintended, adverse consequences for investors. In that regard, we urge the Commission to consider the key concerns and recommendations summarized below and discussed in depth throughout this letter:

Key Concerns

- Contrary to the Advisers Act's longstanding approach to regulating investment advisers, the Proposed Rules needlessly limit the right of private fund advisers and their clients/investors to shape their relationship by agreement through full and fair disclosure and informed consent.

- The Commission overreaches in proposing prohibitions and other restrictions on certain private fund adviser activities that go beyond the authority granted to the Commission by Congress when it adopted Section 211(h) of the Advisers Act.

[3] *See, e.g.*, Release at 16956 ("Enhanced competition from additional transparency may lead to lower fees or may direct investor assets to different funds, fund advisers, or other investments").

- The Proposed Rules are arbitrary or capricious because, for among other reasons, they include provisions that are targeted only at private fund advisers, while excluding other types of client relationships, including client relationships with retail investors.

- The Proposed Rules will have numerous and significant adverse consequences on investors, with limited offsetting benefits, which the Commission failed to adequately consider in conducting its cost-benefit analysis.

- The Proposed Rules are likely to have disproportionate adverse effects on, and to create significant barriers to entry for, smaller and newly-formed investment advisers because such advisers have less ability to increase their management or similar fees, are likely to be unable to bear the additional costs that the Proposed Rules would impose, and require significant flexibility regarding the terms that they negotiate with seed, anchor, and other investors.

Recommendations

- Because of the fundamental concerns discussed above, we urge the Commission to withdraw the Proposed Rules.

- If the Commission desires to better understand the questions and potential concerns it raises in the Release, it should conduct an in-depth research effort, with round tables, an advanced notice of proposed rulemaking, concept release or similar efforts to explore the hundreds of questions included in the Release and to provide a meaningful opportunity for market participants to provide the Commission with sufficient evidence to conduct informed rulemaking, as it has done when considering significant rules in the past.

- Rather than developing prescriptive restrictions and prohibitions that severely impair the right of private fund advisers and their sophisticated investors to define the terms of their advisory relationship, the Commission should, through the many existing tools available: (i) ensure that advisers provide investors with full and fair disclosure of material terms, risks, and conflicts of interest so that investors are able to make informed investment decisions, and (ii) take appropriate remedial action in circumstances in which individual advisers fail to make such disclosures or, more generally, fail to comply with their fiduciary duties or other obligations under the Advisers Act.

- The Proposed Rules should not ban advisers from charging fees and expenses to clients when the fact that such fees and expenses are charged to clients has been fully disclosed and the client has consented to bearing those charges.

- The Commission should permit advisers to allocate fees and expenses when they reasonably believe those allocations are fair and equitable to clients.

- The Proposed Rules should not impose a standard of care on private fund advisers in addition to the one that already applies under the Advisers Act. Doing so in the

manner set forth in the Proposed Rules will impose (i) a higher standard for private fund advisers than the one applicable to registered investment company advisers and (ii) significant costs on advisers that ultimately will be passed on to investors.

II. Key Concerns

While we provide specific comments on the Proposed Rules below, we first want to address what we believe to be several fundamental issues with the Proposed Rules taken as a whole, particularly with respect to the proposed prohibitions on private fund advisers' and sophisticated private fund investors' ability to define the terms of their commercial relationship. The right to "shape that [adviser-client/investor] relationship by agreement, provided that there is full and fair disclosure and informed consent,"[4] is the decades-long hallmark of the Commission's regulatory approach to an investment adviser's fiduciary duty to its clients, including for private fund advisers and private funds. However, the Proposed Rules would needlessly discard that time-tested principle in favor of a series of prohibitions and prescriptive requirements, many of which the Commission has chosen to apply only to private funds advisers, despite the fact that investors in private funds are limited to sophisticated investors that the federal securities laws recognize as having the requisite skill, knowledge, and expertise both to understand and, if desired, to negotiate the terms on which they are willing to invest in private funds.[5]

The Commission's striking departure from its well-established approach to the regulation of private funds and private fund advisers is particularly troubling because of several fundamental Commission failures in issuing the Proposed Rules. To begin with, the Commission overreaches in proposing prohibitions and other restrictions on certain private fund adviser activities that go beyond the authority granted to the Commission by Congress when it adopted Section 211(h) of the Advisers Act. The Commission also fails to provide evidence of significant investor harm that would justify the imposition of draconian rules that are unreasonably targeted at private fund advisers, and instead relies for support on speculative statements and citations to just a handful of academic articles (some of which are only vaguely related to the Proposed

[4] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669, 33671 (July 12, 2019), available at: https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.

[5] As the Commission is aware, the National Securities Markets Improvements Act of 1996 ("**NSMIA**") amended Section 3(c)(1) and enacted Section 3(c)(7) of the Investment Company Act of 1940, reflecting recommendations made by the Commission and its staff. In proposing changes to the Section 3 exclusions from the definition of an "investment company" the Division of Investment Management recommended "an amendment to the Investment Company Act to create a new exception for funds whose securities are held exclusively by "qualified purchasers" as defined by rule. The new exception would be premised on the theory that "qualified purchasers" do not need the Act's protections because they are able to monitor such matters as management fees, transactions with affiliates, corporate governance, and leverage." *See Protecting Investors: A Half Century of Investment Company Regulation*, report of the Division of Investment Management at 104, 105 (May 1992). The legislative history to NSMIA indicates that Congress agreed with the Division's view "the Commission is given flexible authority to establish various definitions of qualified purchasers. In all cases, however, the Committee intends that the Commission's definition be rooted in the belief that ''qualified'' purchasers are sophisticated investors, capable of protecting themselves" H.R. Rep. No. 622, 104th Cong., 2d Sess. 51 (1996).

Rules). Further, the Commission fails to acknowledge or consider the wide range of costs and harms that the Proposed Rules are likely to impose on private fund investors.

The fundamental shortcomings of the Commission's approach are demonstrated by the following discussion of the illogical and unjustified consequences of its proposals. The Proposed Rules would effectively mandate a higher standard of care for private fund advisers than the standard of care applicable to registered investment company advisers. The Proposed Rules would prohibit private fund advisers from allocating certain expenses to clients, likely resulting in less transparency and higher costs to investors. The Proposed Rules also would prohibit private fund advisers from choosing fair and equitable methodologies to allocate expenses among clients unless those methodologies meet an undefined, vague requirement that the expenses be allocated on a pro rata basis. Other provisions of the Proposed Rules would prohibit private fund advisers from providing preferential liquidity terms or information rights to investors, or impose substantial costs to providing preferential terms, which will have the effect of:

- limiting the ability of investors to negotiate terms that are in their best interest;
- imposing additional costs on investors generally;
- chilling the types of direct, tailored communications on which investors rely in their initial and ongoing due diligence related to their investments; and
- limiting product design options of related fund structures that are offered to sophisticated investors (which may vary in liquidity terms).

We also submit for the Commission's consideration, as Appendix A, a report from Professor Craig M. Lewis ("**Lewis Report**"), the Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management and a former SEC Chief Economist and Director of the Division of Economic and Risk Analysis. The Lewis Report focuses on the economic analysis and discussion of efficiency, competition, and capital formation contained in the Release. The Lewis Report identifies fundamental flaws in the Commission's assessment of the Proposed Rules on these topics. Further, the Lewis Report clearly demonstrates that the Proposed Rules will have an overall negative impact on private fund investors, contrary to the Commission's stated objectives. It also clearly demonstrates that the Proposed Rules will have wide ranging and distortive effects on the efficient allocation of capital and the competitiveness of the asset management industry.

In light of the serious concerns regarding the process involved in issuing the Proposed Rules and the significant adverse consequences that the Proposed Rules would have on investors, we strongly encourage the Commission to withdraw the Proposed Rules, particularly those Proposed Rules that would impose prohibitions, unfounded restrictions, or prescriptive requirements on the activities of private fund advisers.

In the following, we describe specific concerns with the Proposed Rules.

A. The Proposed Rules Will Have Significant, Adverse Consequences on Investors

The Proposed Rules will have numerous and significant adverse consequences on investors, with limited offsetting benefits that are not meaningful to investors. Among other things, these negative consequences for investors will include:

- fundamental changes to, and/or the elimination of, certain key fund terms and practices that benefit investors, including redemption provisions designed to meet investor needs;
- inhibiting the ability of investors to conduct robust initial and ongoing due diligence on their investments;
- less effective disclosure that reduces the ability of investors to understand and manage their portfolios as investor reporting is homogenized to provide less useful and/or misleading information instead of the tailored information that investors rely on and expect;
- potential proliferation of opportunistic and frivolous lawsuits under state or foreign law, and increased fees as advisers necessarily make adjustments to account for this potential additional expense;
- reduction or elimination of agreements between advisers and investors (*i.e.*, side letters) that contain terms relevant to a particular investor that are unrelated to other investors' investments in a fund, as well as other beneficial accommodations provided by advisers to their investors, including routine information sharing and communication at the investor's request;
- disclosure of potentially sensitive commercial information in mandated reports (e.g., itemized reporting of trading commissions, financing costs, data and research costs, and other investment-related expenses) and other mandated disclosures (*e.g.*, terms of private contracts with other clients or investors);
- potential conflicts between the prescriptive performance information required to be provided to investors by the Proposed Rules and other performance information frequently requested by investors, including to comply with investors' internal requirements (*e.g.*, Global Investment Performance Standards ("**GIPS**") promulgated by the CFA Institute) or to facilitate comparisons across advisers with which an organization is invested, likely resulting in investor confusion; and
- reduced alignment of interest among advisers and their clients (*e.g.*, through the prohibitions related to clawbacks and certain tax and other advances by private funds as well as the disincentives for advisers to incur compliance-related costs that would otherwise be borne by private funds with appropriate disclosures).

Alternative investment strategies by their nature require more independent research and other data, more investment staff, and often more complex technology to support them than a

typical retail investment product. The likely result of the prohibitions and other rules included in the Release, including but not limited to those related to expenses, is that advisers will charge higher fees, limit the options available to investors, and provide less transparency into the actual costs such fees are meant to offset. There is also a significant risk that advisers could be forced to allocate investment-related expenses among investors in required ways when the adviser believes those expenses could be more fairly and equitably allocated based on the particular facts or circumstances surrounding the resource being allocated or, alternatively, discourage advisers from devoting resources to investment-related research and development because they cannot allocate the costs associated with those items in a manner that they believe to be most appropriate under the circumstances. Ultimately, all of these outcomes are likely to lead to a reduction in the number and quality of investment opportunities made available to investors, which, in turn, will increase costs to investors and financial markets.

The Proposed Rules fail to consider and quantify such consequences or, in many cases, even to acknowledge their existence. In fact, the Commission itself admits that it cannot estimate either the benefit to investors resulting from these far-reaching proposals or the very real costs that will be borne by them as a result.[6] We therefore urge the Commission to suspend this rulemaking process and instead to conduct an in-depth research effort, with round tables, an advanced notice of proposed rulemaking, concept release or similar efforts to explore the hundreds of questions included in the Release and to provide a meaningful opportunity for market participants to provide the Commission with sufficient evidence to conduct informed rulemaking, as it has done with other potential rules in the past.[7] MFA and its members stand ready to be constructive participants in such a process.

B. <u>The Proposed Rules Will Disproportionately Impact Smaller and Newer Firms, thereby Reducing Competition and Diversity in the Private Fund Industry</u>

The Proposed Rules are likely to have disproportionate adverse effects on, and to create significant barriers to entry for, smaller and newly-formed investment advisers. Such advisers have less ability to increase their management or similar fees, are likely to be unable to bear the additional costs that the Proposed Rules will impose, and require significant flexibility regarding the terms that they negotiate with seed, anchor, and other investors to attract investors. These

[6] Release at 16948 ("For example, there is a lack of data on the extent to which advisers engage in certain of the activities that would be prohibited under the proposed rules, as well as their significance to the businesses of such advisers. It is, therefore, difficult to quantify how costly it would be to comply with the prohibitions. Similarly, it is difficult to quantify the benefits of these prohibitions, because there is a lack of data regarding how and to what extent the changed business practices of advisers would affect investors, and how advisers may change their behavior in response to these prohibitions.").

[7] To cite just two examples, we note that the Commission's December 2021 proposed rules on money market funds cited to, among other things, a December 2020 report on money market funds from the President's Working Group on Financial Markets (available at: https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf). In addition to contributing to that report, the SEC solicited and received 55 comments on the potential options for money market fund reform discussed in the report. Similarly, prior to proposing rules regarding market data infrastructure (available at: https://www.sec.gov/rules/proposed/2020/34-88216.pdf), the SEC hosted a public roundtable and solicited public comments (available at: https://www.sec.gov/spotlight/equity-market-structure-roundtables), which helped inform the Commission's rulemaking.

barriers to entry are anti-competitive, stifle innovation, act to limit investor choice, and potentially impede other efforts by the Commission and President Biden's administration to promote greater diversity within the asset management industry. Further, not only will the Proposed Rules create steep barriers to entry for new advisers, but they will lead to consolidation in the industry, thereby reducing competition and the investment choices available to investors.

The alternative investment industry thrives on new entrants, entrepreneurship, and competition. Imposing significant costs and eliminating long-standing industry practices that enable smaller and newer firms to incent early investors and tailor fund terms appropriately will make it harder to launch new firms and harder for new managers to succeed, thereby harming investors' ability to generate returns on behalf of their ultimate beneficiaries. The Proposed Rules, however, do not address these consequences. In fact, the discussion in the Release of the effects on efficiency, competition, and capital formation does not appear to address the effects of this prohibition on competition at all.[8] While the negative impact to the private funds industry in this context speaks for itself, this outcome will necessarily result in harm to investors, who will be left with lesser investment options as a result.

C. Discriminatory Treatment of Private Fund Advisers Lacks Justification

Agency rulemaking must not only provide an evidentiary record as support for rule proposals, but proposed rules also must not be arbitrary or capricious.[9] The Proposed Rules include a number of provisions that are targeted only at private fund advisers, while excluding other types of client relationships, including client relationships with retail investors. The Commission's decision to apply more onerous restrictions on private fund advisers than other advisory relationships, such as advisers to registered investment companies, where the level of investor sophistication and negotiating power is considerably lower, together with the lack of justification in the Proposed Rules or Release for the discriminatory treatment of private fund clients relative to other advisory clients, particularly without meaningful demonstration of a market failure or harm unique to the private fund context, strongly indicates that the Proposed Rules draw distinctions that are arbitrary and capricious in nature.

The disparate treatment of different types of private fund advisers is similarly arbitrary and capricious. For example, the Release specifically states that the proposed prohibited activities would not apply to a *registered* offshore adviser's private funds that are organized outside of the United States, regardless of whether the private funds have U.S. investors. The Release does not include a similar exclusion for an *unregistered* offshore adviser's private funds that are organized outside of the United States. While offshore funds with no U.S. investors may not meet the definition of "private fund" in the first instance, to the extent such funds are private funds for purposes of the Proposed Rules, the Release fails to provide a justification for treating unregistered offshore advisers differently than registered offshore advisers with respect to private funds that are organized outside of the United States. Indeed, the same rationale set out in the Release for excluding offshore private funds of registered offshore advisers from the substantive

[8] *See* Release, Section V.D.2, at 16956.

[9] *See Susquehana Int'l Grp., LLP v. SEC*, 866 F. 3d 442 (D.C. Cir. 2017), citing 5 U.S.C. §706(2)(A). *See also Goldstein v. SEC*, 451 F. 3d 873 (D.C. Cir. 2006).

provisions of the Advisers Act should apply to offshore private funds of unregistered offshore advisers.

D. The Proposed Rules Exceed the Commission's Authority under the Advisers Act

The Proposed Rules include a number of provisions that go beyond the Commission's authority under the Advisers Act and, as such, should not be adopted. The prohibitions in Proposed Rules 211(h)(2)-1 and 211(h)(2)-3[10] go beyond the disclosure-based framework of the Advisers Act[11] that has existed for over 80 years and beyond the scope of Section 211(h) of the Advisers Act, enacted as part of Section 913 of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**"). The substance of Section 211(h), as enacted in the final Dodd-Frank legislation, was initially included in Section 913 of President Obama's administration's proposed regulatory reform package.[12] Section 913 of the administration's regulatory reform proposal and Section 913 of Dodd-Frank generally dealt with (i) harmonizing the standards of conduct for broker-dealers and investment advisers with respect to retail clients and customers, (ii) enhancing the standard of conduct applicable to broker-dealers with respect to retail customers, and (iii) providing authority to the Commission regarding the sales practices of broker-dealers and investment advisers. President Obama's administration released a white paper in connection with its proposed legislative language that demonstrates the administration's concerns in proposing Section 913 were in the context of retail customers and clients.[13] The legislative history surrounding Section 211(h), and Section 913 of Dodd-Frank in general, demonstrates that Section 211(h) was clearly intended to address the relationship between retail clients and their advisers. In expanding the authority provided by Section 211(h) to impose prohibitions and other restrictions on the relationship between private fund advisers and their

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[10] Rule citations in this letter are to rules proposed or adopted under the Advisers Act, unless stated otherwise.

[11] *See, e.g., SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180 (1963).

[12] Section 913 of the Obama administration's proposed legislation included adding Section 211(g) to the Advisers Act as follows:

> "(g) OTHER MATTERS.—The Commission shall—
>
> > "(1) take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals, including consultation with other financial regulators on best practices for consumer disclosures, as appropriate; and
> >
> > "(2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors."

Available at: https://www.llsdc.org/assets/DoddFrankdocs/dodd-frank-act_admn-reg-reform-bill.pdf.

[13] *See Financial Regulatory Reform A New Foundation: Rebuilding Financial Supervision and Regulation*, at 71 (June 17, 2009) ("**Financial Regulatory Reform White Paper**"), available at: https://fraser.stlouisfed.org/title/financial-regulatory-reform-5123. The Financial Regulatory Reform White Paper issued by President Obama's Treasury Department and the accompanying proposed legislation from the administration served as a foundation for financial regulatory reform that was ultimately embodied in Dodd-Frank identifies retail investor confusion between brokerage relationships and advisory relationships and compensation arrangements that "encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in investors' best interest" as the primary policy concerns.

non-retail investors, the Commission has improperly exceeded its authority. By applying the proposed prohibitions to the terms of existing contractual and other commercial arrangements and modifying the standard of care applicable to existing relationships, the Commission also has impermissibly proposed retroactive rules.[14]

Proposed Rule 211(h)(2)-1(a)(5) in particular is inconsistent with the Congressional determination not to create a private right of action under the Advisers Act.[15] By prohibiting private fund advisers from obtaining customary contractual protections with respect to the type of conduct for which advisory clients do not have a private right of action under the Advisers Act, Proposed Rule 211(h)(2)-1(a)(5) effectively creates private litigation rights by regulatory action.

E. Lack of Evidentiary Support and Inadequate Cost-Benefit Analysis

A robust evidentiary record, including a cost-benefit analysis, is an integral part of the rulemaking process. As the Commission is aware, courts have held that rulemaking that is "unsupported by substantial evidence" constitutes unlawful agency action.[16] Further, Section 202(c) of the Advisers Act provides:

> Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[17]

As discussed in more detail below, the Proposed Rules fail to meet these standards. In lieu of a robust evidentiary record, the Commission seems to base its proposed rules on an assumption that private fund advisers generally (as opposed to a limited number of individual advisers) are failing to act in accordance with their fiduciary and contractual obligations. However, this assumption is inconsistent with the Release's repeated lack of documented harm to investors in private funds; the Release simply fails to justify the fundamental changes proposed by the Commission. It is clear that the Commission has not conducted a robust cost-benefit analysis that demonstrates (i) the need for the Proposed Rules; (ii) a thorough assessment of both the costs and

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[14] *See National Min. Ass'n v. Department of Labor*, 292 F.3d 849, 859 (D.C. Cir. 2002). (An agency may not promulgate retroactive rules absent express congressional authority, citing *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208, 109 S.Ct. 468, 102 L.Ed.2d 493 (1988)).

[15] *See Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (Holding that Section 215 creates a limited private right of action to void an advisory agreement and recover fees paid under the voided agreement, but that there is no private right of action under Section 206).

[16] *See Susquehana Int'l Grp., LLP v. SEC*, *supra* note 9.

[17] *See also Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (Finding that the SEC's adoption of Rule 14a-11 under the Exchange Act violated the APA because the "Commission acted arbitrarily and capriciously here because it neglected its statutory responsibility to determine the likely economic consequences of Rule 14a-11 and to connect those consequences to efficiency, competition, and capital formation," requirements similar to those set out in Section 202(c) of the Advisers Act.).

the benefits of the Proposed Rules and their effect on investors and capital formation; or (iii) that less costly alternatives are unavailable. Given these significant flaws, the Proposed Rules, and in particular the prohibited activities and preferential treatment rules, fail to meet the requirements of Section 202(c) of the Advisers Act and the requirements of the APA. Accordingly, the Commission should withdraw the Proposed Rules.

F. The Commission Has Failed to Provide Sufficient Opportunity for Notice and Comment

Given the breadth of the Proposed Rules, the significant departures from the long-standing regulatory framework applicable to private fund advisers, and the legal and practical complexities that would result if the Proposed Rules were to be adopted, the Commission's decision to provide only a 30-day comment period from the date the Proposed Rules were published in the Federal Register does not provide affected market participants sufficient time to review, analyze, and comment on the Proposed Rules. The lack of an adequate period for notice and comment is exacerbated by the volume of recent proposed rulemakings from the Commission affecting the private fund industry that encompass 3,092 pages, all of which provide for a similarly short public comment period.[18] The fact that the Commission has departed significantly from established Commission practice[19] and longstanding Executive Orders[20] regarding comment periods for proposed rulemaking further demonstrates that the comment period for the Proposed Rules is insufficient.

G. The Proposed Rules Depart From Long-Standing Principles Regarding the Regulation of Private Funds and Private Fund Advisers

In proposing rules for private fund advisers, it is critical that the Commission consider the sophisticated nature of investors that are permitted to invest in private funds. Private fund investors are not retail investors. Although the ultimate beneficiaries of many investors in private funds are pensioners and other similar individuals, the entities that invest on their behalf, and the

[18] Politico Morning Money Newsletter reported that, on April 13, 2022, forty-seven lawmakers from both parties called on the Commission to provide longer comment periods for its rulemakings, including the private fund adviser proposal. The lawmakers expressed concerned that some of the comment periods "may hamper the ability for the public to provide effective and meaningful input" on the proposals, noting that the APA requires federal agencies to allow the public a meaningful opportunity to participate in the regulatory comment process. *See* https://www.politico.com/newsletters/morning-money/2022/04/15/biden-picks-barr-as-fed-bank-czar-00025453/. As of April 25, 2022, the Commission has not yet published this letter in the comment file for this proposal.

[19] In 2019 and 2020 combined, 29 out of 33 SEC rule proposals had comment periods of greater than 30 days from the proposed rule's publication in the federal register. In 2015 and 2016 combined, 28 out of 29 SEC rule proposals had comment periods of greater than 30 days from the proposed rule's publication in the Federal Register. *See* March 1, 2022 letter from MFA and 24 other trade associations raising similar concerns regarding the insufficiency of comment periods for recent Commission rulemaking, available at: https://www managedfunds.org/wp-content/uploads/2022/04/Extension-Request-File-Nos.-S7-03-22-S7-01-22.pdf.

[20] *See* Executive Order 12866, Regulatory Planning and Review (Sept. 30, 1993), and Executive Order 13563, Improving Regulation and Regulatory Review (Jan. 18, 2011), each of which calls for agencies to provide a meaningful opportunity to comment with a comment period that should generally be ***at least*** 60 days.

institutional investors that invest in private funds more generally,[21] are managed or advised by highly sophisticated professional investment staff with access to both internal legal counsel and experienced external commercial, legal, and other advisers. In addition, any direct individual investors in private funds, at a minimum, meet accredited investor standards, though many meet the higher qualified purchaser thresholds. These investors also use or have access to professional advisers to source, review, negotiate, and/or monitor their alternative investments. These intermediaries owe their own fiduciary duties to their clients or beneficiaries in making recommendations or investment decisions on their behalf. All of these sophisticated investors, regardless of size, have the resources internally or through external consultants to conduct initial and ongoing diligence on the advisers to whom they allocate resources. As a result, investors who make the decisions on whether to invest in private funds are well equipped to consider the benefits and risks of any potential investment, to monitor their investments over time, and to make informed decisions about redemptions and other terms of their investment. To do so, however, sophisticated investors need the ability to conduct due diligence on their investments, which requires them to have the ability to ask for and receive the information they deem important to their investment decisions. In addition, because most private fund advisers seek a broad and diversified investor base, a typical private fund negotiation often will include the adviser separately negotiating the overall terms of the private fund—and not just side letters—with many, if not substantially all, of the fund's prospective investors and their myriad internal and external advisers. This is not a process in which investors, whether individually or in the aggregate, are in any way lacking in either market power or in understanding of the terms on which they are investing.

It is for this and similar reasons that, historically, a fundamental premise of the federal securities laws has been that these types of investors do not require the same level of oversight, regulation, or mandated disclosures as retail investors. In light of the above, we believe that any Commission rulemaking for private fund advisers must begin with a recognition that private fund investors have the requisite skill, knowledge, and expertise both to understand and, if desired, to negotiate the terms on which they are willing to invest. The Proposed Rules, however, start from a flawed premise that does not appropriately take the sophistication of private fund investors into account, particularly with respect to the proposed prohibitions and preferential treatment rules. Ironically, by needlessly upsetting the carefully balanced arrangements that private fund advisers and their sophisticated investors have developed over many years, we believe that the Proposed Rules will ultimately harm those investors by significantly reducing their ability to negotiate the terms on which they are able to invest in private funds—thereby disrupting the freedom to contract that is a hallmark of the U.S. free market economy and undermining the competitive advantages that U.S. markets have compared to markets in other countries—and reducing the choices of funds that are available to such investors. By encouraging or requiring fundamental changes to certain core private fund terms and practices, the Proposed Rules will have myriad unintended and materially adverse consequences on investors.

[21] *See* Private Fund Statistics Third Quarter 2021, showing private fund beneficial ownership by individuals is only 13.3 percent, available at: https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2021-q3.pdf.

The commercial nature of the contractual relationships between advisers and sophisticated investors means that rules that require or prohibit (or that encourage or discourage) particular contractual terms or particular practices will create economic costs, at least some of which will be borne by investors who would choose to avoid those costs if permitted to negotiate freely in their own interests. In addition, investors will bear costs associated with having to renegotiate terms that would be prohibited under the Proposed Rules or the costs of reallocating their investments, if the investor chooses not to renegotiate or chooses not to accept revised terms. Indeed, given the likelihood that many private fund agreements would need to be modified to come into compliance with the Proposed Rules, all private fund investors are likely to bear costs associated with evaluating those modifications, without receiving any meaningful benefits.

Rather than developing prescriptive rules and prohibitions that severely restrict the ability of private fund advisers and their sophisticated investors to define the terms of their advisory relationship, the Commission should, through the many existing tools available: (i) ensure that advisers provide full and fair disclosure of the material terms, risks, and conflicts of interest associated with the private fund in which an investor is investing so that the investor is able to make an informed decision before investing; and (ii) take appropriate remedial action in circumstances in which individual advisers fail to make such disclosures or, more generally, fail to comply with their fiduciary duties or other obligations under the Advisers Act. Fair and fulsome disclosure, informed consent, and targeted enforcement against bad actors have been, and should continue to be, the bedrock principles on which the Commission's regulation of private fund advisers is built—indeed, these were the guiding principles of the recently enacted amendments to Rule 206(4)-1 ("**Marketing Rule**"), in which the Commission championed a principles-based approach to disclosure and encouraged transparency and a free flow of information from advisers to prospective investors.[22] The Proposed Rules, which replace disclosure and informed consent with absolute prohibitions and other restrictions, stray far from these principles, often without citations to any legal authority or evidentiary support that would support such a seismic shift in regulatory approach. The Proposed Rules also fail to consider the adverse consequences on investors, including the chilling effect the Proposed Rules will have by prohibiting or creating significant disincentives for advisers to provide investors with the kind of thoughtful, tailored discussions that investors seek and that the Marketing Rule was intended to encourage. The Commission's decision to insert itself into the commercial negotiations of highly sophisticated parties, particularly without giving adequate consideration to the harmful effects the Proposed Rules are likely to have on investors, is a deeply troubling development, and clear overreach of its authority.

III. <u>Prohibition on Indemnification/Exculpation for Breach of a Fiduciary Duty, Willful Misfeasance, Bad Faith, Negligence, or Recklessness</u>

Proposed Rule 211(h)(2)-1(a)(5) would prohibit an adviser to a private fund from seeking reimbursement, indemnification, exculpation or a limitation of its liability for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to

[22] *See* Investment Adviser Marketing, 86 Fed. Reg. 13024 (Mar. 5, 2021), available at: https://www.govinfo.gov/content/pkg/FR-2021-03-05/pdf/2020-28868.pdf.

a private fund. The consequence of the Proposed Rule would be to effectively create a revised standard of conduct for private fund advisers. We believe that this Proposed Rule would fundamentally change the risk profile of advising private funds and will in turn have numerous, materially adverse consequences for investors.

A. The proposed prohibition exceeds the Commission's statutory authority

We believe that establishing a new liability standard for private fund advisers is clearly beyond the scope of authority set out in Section 211(h). Congress specifically addressed the standard of conduct for investment advisers in Section 913 of Dodd-Frank by adding Section 211(g) to the Advisers Act. Section 913 of Dodd-Frank also required the Commission to conduct a study to evaluate the standard of conduct for broker-dealers and investment advisers. Both the study and Section 211(g) specifically focused on the standard of conduct as it pertains to providing advice to retail customers. None of the provisions in Section 913 of Dodd-Frank pertaining to the standard of conduct for investment advisers are directed toward investment advice provided to non-retail clients, and in fact Section 211(g) prohibits the Commission from defining "customer" to include investors in private funds.[23] This language makes clear that Congress did not intend the standard of conduct provisions in Section 913 to apply to private funds or their investors.

Further, unlike Section 211(g), Section 211(h) does not mention the Commission issuing rules to establish a new standard of conduct for investment advisers at all. Given that Congress specifically addressed the standard of conduct applicable to investment advisers in other provisions of Section 913 of Dodd-Frank, but not in enacting new Section 211(h) of the Advisers Act, and given that the discussion of standards of conduct in Section 913 of Dodd-Frank focused exclusively on retail clients, we believe that the Commission is incorrect in asserting authority to issue rules under Section 211(h) to change the standard of conduct applicable to advisers to private fund clients.

Not only does the new liability standard exceed the scope of authority set out in Section 211(h), Proposed Rule 211(h)(2)-1(a)(5) is inconsistent with the Congressional determination not to create a private right of action under the Advisers Act. By prohibiting private fund advisers from obtaining customary contractual protections with respect to the type of conduct for which advisory clients do not have a private right of action under the Advisers Act, the Proposed Rules effectively create private litigation rights by regulatory action. In essence, the Commission appears to be trying to do an end-run around Congressional limitations on private rights of action under the Advisers Act and similar limitations under state law by proposing a rule designed to facilitate the ability of advisory clients or fund investors to bring litigation claims with respect to conduct that cannot be the subject of private litigation under the Advisers Act or under similar state laws (for example, if an adviser's negligence led to a client not receiving best execution for a trade).

[23] *See* Section 211(g) ("The Commission shall not ascribe a meaning to the term 'customer' that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.").

B. The proposed prohibition fails to justify subjecting private fund advisers to a higher standard of care than other advisers

The Proposed Rule would create a higher standard of care for private funds and their sophisticated investors than the standard of care applicable to any other type of investment advisory client, including advisers to registered investment companies and their retail investors, which is a completely illogical outcome for which the Release provides no justification. Section 17(i) of the Investment Company Act of 1940 ("**Investment Company Act**") provides limitations on the ability of the adviser of or principal underwriter for a registered investment company, respectively, to limit their liability for certain types of conduct. Section 17(i) of the Investment Company Act prohibits a registered investment company from entering into an advisory agreement that "protects or purports to protect [the adviser] against any liability to such [investment company] or its security holders to which [the adviser] would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of [the adviser's] duties, or by reason of [the adviser's] reckless disregard of his obligations and duties under such contract or agreement."[24] As such, the Investment Company Act generally permits an investment adviser to a registered investment company to contractually limit its liability for ordinary negligence and shape the nature of its fiduciary duty.

Because advisers to registered investment companies are subject to the same limitation as private fund advisers with respect to seeking a general waiver of their federal fiduciary duties, the Commission's assertion that a contractual waiver for ordinary negligence is invalid under the Advisers Act is inconsistent with a plain reading of Section 17(i) of the Investment Company Act and would result in a practice that is permissible under the Investment Company Act being deemed impermissible under the Commission's new interpretation of the Advisers Act, a result that, because it lacks reasonable justification, is arbitrary and capricious, and clearly beyond the authority of the Commission.

The Release fails to mention this disconnect in the proposed restrictions on private fund advisers compared to registered investment company advisers and, as a result, provides no justification or analysis for why it would be reasonable to subject private fund advisers to a comparatively higher standard of care (especially when the investors in private funds are required to be more sophisticated than retail investors in registered investment companies and the investment strategies operated by advisers to registered investment companies are typically far less complex than the ones operated by private fund advisers). While the Release states the Commission's view that waiver and indemnification agreements have become more aggressive over time, the Release does not cite to any enforcement cases or other examples of actual harm to sophisticated investors as support for imposing such a broad prohibition on private fund advisers.

Similarly, the Release does not explain why private fund advisers should be subject to this prohibition when advisers to other types of advisory clients are not. This lack of explanation is particularly troubling in light of the Commission's statements in the Release regarding the ability of an adviser to seek indemnification, which should not lead to selective application of the

[24] 15 U.S.C. §80a-17(i). Section 17(h) of the Investment Company Act has a similar provision regarding contractual limitations on liability of officers and directors of registered investment companies.

prohibition to only certain types of investment advisory client relationships, especially when the "protected" clients are most able to negotiate effectively for themselves.

C. The Commission fails to conduct an adequate cost-benefit analysis in support of the proposed prohibition

i. The Release misapplies the standard of care and misapprehends contractual limitations

The Release begins by observing that many private fund advisers seek to limit their duties and liabilities to investors under state and non-U.S. law and cites such limitations as justification for the adoption of Proposed Rule 211(h)(2)-1(a)(5). The Release also notes that certain advisers attempt to limit their duties under the Advisers Act. Although we cannot express a view as to the prevalence of such provisions, we do agree that an adviser's federal fiduciary duty cannot be waived in general, though the contours of those duties can be shaped by agreement. That is, an adviser cannot seek to obtain a waiver of its status as a fiduciary under the Advisers Act or a blanket waiver of all conflicts of interest but can, through agreement with a client, shape the adviser's particular obligations so long as the adviser does not seek to waive specific obligations under the Advisers Act. Accordingly, we urge the Commission to revise the Proposed Rule such that it would require advisers to provide clear disclosure to investors that, notwithstanding any limitations of liability under state and non-U.S. law, the adviser's duties under the Advisers Act cannot be waived in general. In particular, we note that the problem identified in the Commission's historical guidance with respect to so called "hedge clauses" is primarily a problem of disclosure (at least as it pertains to non-retail investors). It stands to reason then that the optimal solution to the Commission's stated concerns likewise would be disclosure-based rather than the substantive prohibition embodied in Proposed Rule 211(h)(2)-1(a)(5). The summary dismissal of disclosure in the Release demonstrates that the Commission failed to give reasonable consideration to that as an alternative to the proposed prohibition.

Further, we believe that the Release misapprehends both the purpose and effect of existing contractual limitations and, in so doing, fails to consider the significant negative consequences for investors that are likely to result from this prohibition. Sophisticated investors agree to contractual provisions in which advisers can limit their liability under state and non-U.S. law but remain subject to their federal fiduciary obligations, not because those investors fail to understand their rights or lack market power to insist on an alternative, but because it is in investors' interest to do so. Specifically, the investment strategies offered by private funds are among the most differentiated, highest returning, and most sought-after strategies available; however, these strategies can be very complex and are subject to various risks. Critically, sophisticated parties rationally agree to certain risk and cost trade-offs in the pursuit of such differentiated strategies, as discussed below. Some strategies also involve the fund operating in non-U.S. markets where legal systems may be less developed or reliable. The existing legal framework achieves a critical balance by ensuring that investors can engage advisers that are subject to fiduciary obligations under the Advisers Act while also ensuring that advisers can obtain a reasonable degree of protection from liabilities (including frivolous or opportunistic private lawsuits) as all businesses do. Upsetting this balance, as the Proposed Rule would do, will have numerous unintended and adverse consequences for investors.

An adviser's status as a fiduciary under the Advisers Act is inviolate and cannot be subject to a blanket or general waiver, and limitations of liability under state and non-U.S. law have no effect on such federal fiduciary duties. However, this restriction under federal law does not provide the Commission with authority to prohibit waivers of duties under state law. Moreover, an adviser's failure to act in accordance with its federal fiduciary duty is very likely to result in a Commission enforcement action with the consequent monetary penalties and reputational damage that can be existential to an adviser's continued operation. As a result, advisers have powerful incentives to act in accordance with such fiduciary duties, even though the Advisers Act does not provide for a private right of action. In addition, investors can take various other actions to protect their interests, including under the private fund's governing documents, pursuant to Rule 10b-5 under the Securities Exchange Act of 1934 ("**Exchange Act**"), and under applicable state anti-fraud laws.

ii. The proposed prohibition would have significant adverse consequences

The adverse consequences to investors of Proposed Rule 211(h)(2)-1(a)(5) are likely to be myriad and material, and yet the Release provides scant discussion of the potential costs, identifying only the possibility that advisers will obtain alternative compensation from investors to offset their relatively greater liability under the Rule. We believe the significantly increased risk of frivolous lawsuits will cause greater harm than mere increases in insurance costs (although those are likely too). First, the Release does not appear to consider the possibility that the prohibition will significantly increase the incidence and cost of actual or potential litigation related to private funds. Simple negligence and a specific breach of a fiduciary duty are standards that are relatively easy to allege in litigation and cases based on such claims are unlikely to be disposed of quickly before the parties will incur significant costs. As a result, the proposed prohibition creates the very real possibility that private funds will become subject to a dynamic in which any adverse development may result in expensive and distracting lawsuits whether or not the underlying claims have merit. The Release fails to adequately consider those costs or to demonstrate any need to revise the standard of care given the Commission's established interpretation regarding the limitations on an adviser's ability to limit its liability or waive its fiduciary obligations.

In addition to changes resulting from the higher incidence and cost of actual or potential litigation, we believe that private fund advisers are likely to respond to these increased risks in one or more other ways that will adversely affect investors in private funds. The Commission is correct that some advisers will increase their fees to compensate for the risk and costs of private lawsuits and also for potential liability related to trade and other errors that neither violate the applicable standard of care nor industry standard liability provisions in advisory contracts. Although the Release asserts that fee increases will be "limited," it does not cite any evidence for this conclusion.

Moreover, even if an adviser is unwilling or unable to raise its fees, the Proposed Rule creates powerful incentives for such advisers to compensate in other ways, whether through offsetting changes to a private fund's governing documents (including changes to various non-economic provisions) and/or by engaging in behavior to reduce the risks of liability, but with negative consequences to the private funds and its investors. For example, the changes to the

standard of care applicable to private fund advisers will discourage them from engaging in more complex strategies and activities where mistakes are more likely. Under the Proposed Rule, simple errors that produce losses will require reimbursement from the manager, but errors that result in gains will not. This asymmetric risk will serve as a powerful disincentive to managers from making trades that would be in the interest of investors. It also will result in decreased competition and diversification. And this will likely result in industry consolidation as larger asset managers will have the scale and ability to absorb the costs. These unintended consequences are clearly contrary to the interests of private fund investors, who are well aware of such risks and, in fact, often invest in private funds expressly to gain exposure to the investment returns that are enabled by expert management and mitigation of such risks. Nevertheless, the proposed prohibition will deprive sophisticated investors of the ability to pursue such strategies by making their own determination as to risk-reward trade-offs. These consequences would be to the substantial detriment of investors, but the Release fails to adequately consider the costs associated with these likely responses in its economic analysis.

Similarly, if private fund advisers can no longer limit the ability of clients or investors to litigate under a private fund's governing documents for perceived specific instances of negligence or breach of fiduciary duty, private fund advisers are very likely to consider limiting or excluding certain types of investors that are deemed to create heightened risk of initiating lawsuits against advisers under the new proposed standard, which would limit such investors' access to some or all private funds. Investors subject to the Employee Retirement Income Security Act of 1972 ("**ERISA**") are already subject to a similar dynamic in which their access to private funds is limited by many advisers to, in aggregate, 25% or more of any class of equity interests in a fund so that the adviser does not become subject to the requirements of ERISA. The Proposed Rule is likely to have a similar, albeit potentially more dramatic effect on certain categories of investors. This consequence would be to the substantial detriment of investors, but the Release fails to adequately consider the costs associated with these likely responses in its economic analysis.

The Release also fails to consider additional costs on advisers that would result from the proposed prohibition. First, the cost for advisers to obtain directors' and officers' and errors and omissions insurance, which has become increasingly expensive in recent years, is likely to increase significantly, assuming that advisers will be able to obtain adequate coverage for the additional potential liabilities. Many advisers likely will need to self-insure against a potentially significant amount of liability and expenses, which will likely lead to increased fees for investors to compensate for the increased risk being assumed by the adviser with self-insurance. In addition, many service providers retained by investment advisers (such as administrators, custodian, prime brokers, and others) insist on including contractual indemnification and exculpation provisions that have a gross negligence standard. As such, if the Commission's prohibition were adopted as proposed, private fund advisers would face an increased risk of being liable for the negligent acts of service providers, while simultaneously being unable to seek indemnification from such service providers. Advisers could choose to mitigate this risk by performing certain functions in-house rather than outsourcing them, even if third parties could be better suited to perform those functions. This result would be suboptimal from a client

perspective. Smaller advisers would be disproportionately impacted as they have fewer resources to perform additional functions in-house.

iii. The Release fails to provide legal authority for the proposed prohibition

In addition to not accounting for these significant economic and other consequences for investors and advisers, the proposed prohibition also is unsupported in the Release by any citation to legal authority. Instead of citing to legal authorities as support for this Proposed Rule, the Release instead cites principally to a limited number of academic articles for support. Citing to a small number of articles is an insufficient basis for so significant of a change to long-standing legal principles regarding an investment adviser's ability to shape the contours of its relationship with clients.

It is noteworthy in this regard that one of the articles cited for support by the Commission[25] does not appear to be of particular relevance to contractual agreements between advisers and private fund clients, which are agreed to by sophisticated investors. The Release cites the article for the proposition that "an investor is induced to 'sign away fundamental protections' without understanding the importance of those protections, without understanding the meaning of certain legal terms, and sometimes without reading the documents the investor signs."[26] The Release fails to note, however, the referenced article is discussing limited liability company ("**LLC**") statutes generally, not the Advisers Act or adviser-client relationships, and, immediately preceding the language cited to by the Commission, the article makes clear its concern relates to the lack of sophistication of many investors in LLCs, stating:

> LLCs' flexible governance approach has gained significant traction, but it is not without its critics. These critics focus on the negative effects from combining mere default protections with less sophisticated owners who undervalue owner safeguards. There are no minimum standards for who can become an owner of an LLC.[27]

An article that discusses concerns related to unsophisticated investors in LLCs bears little, if any, relevance to a proposed rule addressing contractual language agreed to between an investment adviser and sophisticated private fund investors. Reliance on this article underscores the lack of a foundation on which to base this proposed prohibition, particularly in the light of the significant costs associated with the prohibition.

The Release also cites to the Commission's 2019 Interpretation Regarding Standards of Conduct for Investment Advisers ("**Fiduciary Interpretation**") as support for the proposed prohibitions.[28] The Proposed Rule, however, is in direct conflict with the Fiduciary Interpretation, which stated that so-called "hedge clauses" between private fund advisers and

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[25] *See Protecting LLC Owners While Preserving LLC Flexibility*, University of California, Davis Law Review, 51 U.C. DAVIS L. REV. 2129, 2133, Professor Peter Molk (2018) ("**LLC Article**").

[26] Release at note 170.

[27] LLC Article, *supra* note 25, at 2133.

[28] Release at note 171.

their sophisticated investors may be appropriate, depending on the facts and circumstances. In stating this conclusion, the Commission also noted that the sophistication level of the client is a key factor in determining whether a negotiated indemnification clause is consistent with the Advisers Act. Critically, the Fiduciary Interpretation did not prohibit advisers from seeking to limit their liability under state law or non-U.S. law.

The Commission's proposed Interpretation Regarding Standards of Conduct for Investment Advisers included language regarding an adviser's ability to waive its federal fiduciary duty[29] that commenters indicated was overly broad and encouraged the Commission to clarify to say that an adviser cannot seek a blanket waiver of all conflicts of interest or that the adviser will not act as a fiduciary.[30] In response to those comments, the Commission modified the language in the proposed interpretation, stating in the Fiduciary Interpretation:

> A contract provision purporting to waive the adviser's federal fiduciary duty generally, such as (i) a statement that the adviser will not act as a fiduciary; (ii) a blanket waiver of all conflicts of interest; or (iii) a waiver of any specific obligation under the Advisers Act, would be inconsistent with the Advisers Act.[31]

Unlike the Fiduciary Interpretation, Proposed Rule 211(h)(2)-1(a)(5) would prohibit an adviser from seeking reimbursement, indemnification, exculpation, or limitation of its liability for, among other things, a breach of its duty. This statement appears to be even broader than the problematic language in the proposed Fiduciary Interpretation and represents a significant departure from the final Fiduciary Interpretation regarding an adviser's ability to limit its liability based on the particular facts and circumstances (including based on the sophistication of a client), and yet the Release does not provide any legal basis or evidentiary support for such a fundamental change in the Commission's established interpretation of an adviser's ability to shape the contours of its obligations.

iv. Recommendation

The proposed prohibition suffers from a number of fundamental deficiencies, including the lack of (i) statutory authority; (ii) justification for applying the proposed prohibitions only to private fund advisers; and (iii) an evidentiary record supporting the proposed prohibition and the full range of costs associated with the prohibition. Accordingly, we strongly encourage the Commission to withdraw this proposal.

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[29] Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, 83 Fed. Reg., 21203, at 21205-21206 (May 9, 2018), available at: https://www.govinfo.gov/content/pkg/FR-2018-05-09/pdf/2018-08679.pdf.

[30] *See* Comment Letter of the Hedge Funds Subcommittee of the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association (Aug. 24, 2018), available at: https://www.sec.gov/comments/s7-09-18/s70918-4260675-173078.pdf.

[31] Fiduciary Interpretation, *supra* note 4, at 33672.

IV. Prohibition on Charging Private Funds Certain Fees and Expenses

Proposed Rules 211(h)(2)-1(a)(2) and 211(h)(2)-1(a)(3) would prohibit a private fund adviser from charging a private fund fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority. It also would prohibit a private fund adviser from charging regulatory or compliance fees and expenses of the adviser or its related persons to a private fund. The Release highlights that the proposed prohibition would require advisers that use a pass-through expense model to move to an alternate approach, although the Release does not address the fact that moving to an alternate approach is not entirely within an adviser's control, as it would require investors to agree to such a change. Further, the Release fails to adequately consider the additional costs that are likely to be borne by investors if the proposed prohibitions were to be adopted.

A. The proposed prohibition exceeds the Commission's statutory authority

The statutory context and legislative history related to Congress enacting Section 211(h) of the Advisers Act make clear that the proposed prohibitions on charging certain fees and expenses is beyond the scope of the Commission's authority under Section 211(h). Section 211(h) provides the Commission with authority to address sales practices, conflicts of interest, and compensation schemes. The Release fails to articulate how an adviser charging private fund clients specific expenses that have been fully disclosed creates a conflict of interest for the adviser, particularly when advisers are permitted to charge clients a management fee that is less transparent and incorporates estimates of the same types of expenses. This lack of discussion is not merely an oversight, it is a result of the fact that charging clients fully disclosed expenses that are related to the operation of an advisory business is not a conflict of interest, it simply is a highly transparent business model that provides clients an alternative to a fee-based model. Clients always pay for some portion of the costs of an adviser's business, and the expense pass-through model does not create new or additional conflicts of interest compared to other models (*e.g.*, management fees) that are designed for similar business and economic purposes.

With respect to the other provisions in Section 211(h), as discussed above, Section 211(h) was incorporated into the Advisers Act by Section 913 of Dodd-Frank, in connection with Congressional consideration of the standard of conduct for broker-dealers and a Congressional desire to create a more harmonized standard between brokers and investment advisers with respect to retail customers and clients. The Financial Regulatory Reform White Paper, which served as the basis for many of the provisions in Dodd-Frank, articulates that the policy concerns underlying that provision related to retail investor confusion between brokerage relationships and advisory relationships and compensation arrangements that profit the intermediary, but are not in investors' best interests. While not specified in the White Paper, issues such as selling (i) proprietary investment products that generate additional revenue to the broker or adviser or broker compared to non-proprietary products; (ii) investment products that provide a broker or adviser with additional fees (*e.g.*, revenue sharing from a third party); or (iii) sales incentives that compensate employees for the sale of specific securities are examples of the types of arrangements contemplated by Section 211(h), not an adviser's arrangements to charge a private fund fees and expenses that have been fully disclosed and agreed to by the fund and its sophisticated investors. The Commission's decision to expand the scope of Section 211(h) to

cover expenses that have been disclosed and agreed to by sophisticated investors is not supported by this legislative history or by the clear statutory construct and context of Section 913 of Dodd-Frank.

We note that it was these kinds of issues, not charging a client expenses that the client agreed to pay, in the context of retail customers of broker-dealers that were the focus of the Commission's proposal and adoption of Regulation Best Interest (including the very narrow scope of compensation arrangements that are prohibited under Regulation Best Interest).[32] Regulation Best Interest was based on Section 15(l)(2) of the Exchange Act, which was enacted as part of Section 913 of Dodd-Frank and contained identical language to Section 211(h). The legislative history to Section 913 and the scope of the Commission's rules adopted under Section 15(l)(2) demonstrate that the proposed prohibition on charging private fund clients agreed upon expenses is well beyond the scope of sales practices and conflicts of interest that Congress authorized the Commission to address pursuant to Section 211(h) of the Advisers Act.

Moreover, as drafted, this prohibition would apply well beyond the scope of the federal securities laws and the Commission's authority, indeed it would apply to a wide range of federal, state and local, and non-U.S. agencies, including with respect to regulations, examinations, or investigations that apply to all businesses (*e.g.*, occupational safety or local masking mandates). It is clear from the text of 211(h) and the legislative history of Section 913 of Dodd-Frank that the Commission's delegated authority does not extend to an adviser charging clients for these types of ordinary business costs in the same way that other businesses charge their customers, directly or indirectly, for such costs.

B. <u>The proposed prohibition fails to justify subjecting private fund advisers to a different standard than other advisers</u>

The Release also fails to provide a basis for applying the prohibition only to private fund clients of an adviser and not to other types of advisory clients. The Release simply makes passing reference to the fact that the activities covered by the rule may relate to other types of client accounts and justifies this discriminatory treatment by referencing what it views as purported opacity in the private fund structure. This passing reference does not provide a meaningful basis on which to distinguish between different client types and, as such, appears to reflect an arbitrary distinction between private fund clients and other advisory clients. In addition, if opacity related to fees and expenses is of primary concern to the Commission, it has failed to demonstrate why requirements for advisers (existing or new) related to transparency and disclosure would *not* be a less costly but still effective alternative to address the Commission's policy concerns. In that regard, the Release does not address the extensive disclosures that private fund advisers already provide to investors, particularly with respect to expenses that the adviser passes through to a fund client. Even if the Commission could demonstrate that existing disclosures do not fully address its policy concerns, the Release fails to address why additional reporting requirements would not adequately address the opacity concerns raised in the Release.

[32] *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 3318, at 3331 (July 12, 2019), available at: https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf.

C. The Commission fails to conduct an adequate cost-benefit analysis in support of the proposed prohibition

i. The Release fails to provide legal authority for the proposed prohibition

In proposing this sweeping prohibition, the Release does not cite to any legal authority that supports a ban on advisers charging fees and expenses to clients when the fact that such fees and expenses are charged to clients has been fully disclosed and the client has consented to bearing those charges by agreeing to invest in a fund based on the disclosed terms. Instead, the Release simply cites the Commission's belief that an investment adviser and the owners of the adviser should bear certain costs related to operating an advisory business. The Commission's reasoning is flawed, however, because amounts that clients pay to an adviser, whether structured as a management fee, as an expense pass-through, or some combination thereof, are intended to allow the adviser to pay for the costs of running its business. The Commission's claim that charging clients for certain costs is contrary to the public interest because an adviser has an incentive to place its own interest ahead of the client's interest also is fundamentally inconsistent with the compensation element of the definition of "investment adviser," because compensation from clients is both required for a person to be an investment adviser and an adviser negotiating its compensation structure is always doing so, in part, to pay for its costs of operating an advisory business (*i.e.*, the adviser is acting in its own interest). In essence, the Proposed Rule simply reflects the Commission's view that it does not like a particular economic arrangement, which is not sufficient basis for rulemaking.

The Release provides as an example for support of the prohibition that an adviser may charge a fund significant fees and expenses in connection with an investigation that may not be in the fund client's best interest. The Commission provides no color or context for what is meant by this. The Release does not cite to enforcement actions or other evidence of such abuses occurring with any regularity,[33] but instead cites the theoretical concern—that of an adviser charging significant fees and expenses to a fund in connection with an investigation of the adviser—as a basis for a wide-ranging prohibition. While this example may, depending on the particular facts, represent a reasonable policy consideration in the case of examinations or investigations that ultimately result in a settlement or a finding that the adviser has in fact violated its fiduciary or other obligations, most examinations conclude without the Commission bringing an enforcement action and investigations may conclude without any determination of wrongdoing on the part of an adviser. Further, the Commission can enter into settlement agreements with advisers in which the Commission sets an expectation that the adviser will not pass related costs and/or penalties to investors. More fundamentally, a theoretical example in the absence of evidence demonstrating such abuses occur with any regularity simply does not, by itself, provide evidence or sufficient support for the broad proposed prohibition. The Release also fails to justify why disclosure, combined with the Commission's examination and enforcement authority, does not adequately address any policy concerns articulated in the Release, a fact that is highlighted by the lack of enforcement actions cited to in the Release.

[33] Footnote 26 in the Release cites to one example of a settled enforcement action related to an adviser charging certain expenses that the Commission determined were not ***adequately disclosed*** to clients.

ii. The Release fails to adequately consider the nature of the expenses it would prohibit being passed to private fund clients

Given the highly regulated nature of the private fund industry, investigations and examinations occur in the ordinary course of conducting an investment management business and the existence of an investigation or examination does not mean that a private fund adviser has done anything improper. Such examinations and investigations are, in the first instance, fact-finding exercises. For example, the Commission, the National Futures Association ("**NFA**"), and the Financial Industry Regulatory Authority ("**FINRA**") all conduct regular course examinations of registered entities. If, however, the Commission is concerned about advisers passing through costs after an investigation has determined that an adviser should pay a penalty or fine for its conduct, the Commission should continue to address its expectations that certain costs should not be allocated to fund clients as part of the settlement agreement process.

We also want to highlight that, unlike the discussion in the Release in connection with Proposed Rule 211(h)(2)-1(a)(3) regarding regulatory and compliance expenses, the discussion in the Release in connection with Proposed Rule 211(h)(2)-1(a)(2) does not appear to differentiate between examinations and investigations that relate to advisers in their capacity as advisers (*e.g.*, investment adviser examinations routinely conducted by the Commission) and examinations and investigations that involve an adviser but relate to the activities of a private fund (*e.g.*, a tax audit or an examination or investigation conducted by a state or non-U.S. licensing or other similar authority in connection with regulated investment activities, such as direct lending or reinsurance, or an investigation with respect to which the fund or the adviser is a potential witness or victim). Examinations or investigations that are ordinary course investment-related expenses are no different from the costs of retaining outside counsel to perform investment due diligence or to negotiate transaction documents, and the Release provides no justification for why these sorts of investment activities should be disfavored or discouraged relative to investment strategies that do not require the incurrence of such costs.

iii. The Release fails to consider factors that support passing through expenses

The Release also fails to address the fact that the performance compensation that most private fund advisers can earn already aligns the incentives of the adviser and investors and mitigates the potential conflict identified by the Commission. In particular, such compensation is typically determined net of any expenses borne by the applicable private fund, which means that the adviser bears a portion of the expenses charged to the private fund as a result of its performance compensation (*i.e.*, if an adviser is entitled to receive a performance allocation that is determined net of expenses, the adviser effectively bears a portion of those expenses). Further, passing through expenses creates an incentive for advisers to manage those costs efficiently because investors have significant transparency with respect to those costs.

Prohibiting pass-through expenses, which provide a high degree of transparency, seems inconsistent with the Commission's statements elsewhere in the Release regarding opacity in private fund structures. For example, in proposing quarterly statements, the Commission has focused on increased transparency related to fees and expenses. However, prohibiting the pass-through of certain types of expenses creates incentives for advisers to replace such expenses with

increased management or similar fees, which would reduce rather than promote transparency for investors. Similarly, given the multiple statements in the Release regarding the Commission's concerns about opacity, limiting use of a model that inherently involves transparency of expenses borne by investors is inconsistent with the Commission's underlying objectives.

iv. The Release fails to address its proposed inconsistent treatment of different expense and fee models

The Release also fails to address the inconsistency in prohibiting advisers to private funds from charging certain expenses to private fund clients when an adviser is permitted to charge a management or similar fee that could incorporate estimates of such expenses. As a result, private fund clients are likely to be charged more than the actual cost of such expense since a management fee structure is likely to be less precise insofar as it is based on projected cost estimates, perhaps with a buffer to reflect the potential of cost overruns, which may ultimately prove both inaccurate and larger than necessary. Similarly, the Release fails to adequately consider the likelihood that advisers will simply compensate by charging or increasing management or other new or existing fees to investors, thus likely increasing the overall cost to investors of investing in private funds. While the Release asks about this potential outcome, the Commission does not adequately address it in its economic analysis. This outcome is particularly likely in the context of expenses associated with regulatory examinations and investigations, which can vary significantly from year to year.

The Release fails to demonstrate that a pass-through expense model or the charging of specific expenses to private fund clients with appropriate disclosure, as compared to other types of fee arrangements, are not in the best interest of investors or somehow raise an inherent conflict. This is simply not the case, and the Commission provides no evidence to support this flawed premise. Further, investors agreeing to these terms are sophisticated investors that the Advisers Act and other federal securities laws deem to have the knowledge, expertise and resources to look out for their own interests. Private fund investors have myriad economic arrangements to choose from. If private fund clients were not supportive of a pass-through expense model, they would not invest with private fund advisers who offer such a model and the model would not exist. The Proposed Rule is a significant overreach in prohibiting expense models that are transparent, agreed to by sophisticated investors, and represent a fair method of allocating actual expenses among sophisticated parties, particularly in light of the fact that investors have ample choices in the market to select private fund advisers that use different compensation models. Moreover, the proposed prohibition would require a modification to an advisory business that seeks to use a full expense pass-through model, despite the fact that some investors have specifically chosen to retain a manager that uses such a model, and the Release fails to provide any meaningful justification for such a draconian result.

v. The Release does not consider the full scope of economic consequences of the proposed prohibition

The Release also does not consider the potential impact that the prohibition could have by creating an economic disincentive for advisers to allocate resources to regulatory compliance. Decisions about allocating resources are rarely a bright line test or a matter of legal necessity.

They instead reflect a balancing of business interests, regulatory considerations, and client expectations. In a fundamental failure of the Release's economic analysis, however, the Release does not address this potential unintended consequence nor acknowledge the benefit to investors that can arise from allowing investors to agree to pay certain regulatory or compliance costs, which can help ensure that private fund advisers devote the resources to compliance that investors expect, irrespective of the adviser's assets under management or performance.

Further, the proposed prohibition is likely to create significant barriers to entry for smaller and newly-formed investment advisers, which may have less ability to increase their management or similar fees and are less likely to be able to bear the additional costs that the prohibition would impose. Alternatively, smaller advisers may elect to merge with larger managers that are better able to bear the additional costs, increasing concentration in the asset management industry. These factors act to limit investor choices and potentially impede other efforts by the Commission and President Biden's administration to promote greater diversity within the asset management industry.

The proposed prohibition could also distort adviser choices in ways that harm investors. Advisers could choose, for example, to limit their investor base to a relatively small number of large investors to reduce the costs of providing services to investors. Similarly, non-U.S. advisers could choose to no longer allow U.S. investors into their non-U.S. funds. The proposed prohibition also could create disincentives for advisers to pursue strategies that may give rise to greater regulatory, compliance, and examination costs (for example, strategies that involve more complexity, more counterparties, diversified strategies, or trading in more markets), to the extent that those costs cannot be passed through to clients. This could result in advisers choosing not to create new funds or choosing not to pursue innovative investment opportunities. The Release, however, does not address these effects on efficiency, competition, and capital formation at all.

Moreover, as the Release itself notes, the distinction between fund expenses and adviser expenses may not always be clear. We agree. More pointedly, in the absence of a bright line distinction between fund expenses and adviser expenses, Proposed Rules 211(h)(2)-1(a)(2) and 211(h)(2)-1(a)(3) will create more uncertainty for both private fund advisers and sophisticated investors. Consequently, the proposed prohibition creates a vague standard that would be difficult for advisers to rely on *ex ante* in determining which expenses are subject to the prohibition.

vi. Recommendation

The proposed prohibition suffers from a number of fundamental deficiencies, including the lack of (i) statutory authority; (ii) justification for applying the proposed prohibitions only to private fund advisers; and (iii) an evidentiary record supporting the proposed prohibition and the full range of costs associated with the prohibition. Accordingly, we strongly encourage the Commission to withdraw this proposal.

V. <u>Prohibition on Non Pro-Rata Expense Allocations</u>

Proposed Rule 211(h)(2)-1(a)(6) would prohibit a private fund adviser from 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. In the Release, the Commission states its belief that "any non-pro rata allocation of fees and expenses under these circumstances is contrary to the protection of investors because it would result in the adviser placing its own interest ahead of another's, including in circumstances where the adviser indirectly benefits by placing the interest of one or more clients or investors ahead of another's."[34]

Generally, we believe that advisers need the ability to allocate fees and expenses on a basis that they reasonably believe to be fair and equitable in light of the circumstances. If the phrase "related to a portfolio investment" were interpreted broadly, there are a range of circumstances in which investment advisers may allocate fees and expenses related to a portfolio investment (or potential portfolio investment) in a fair and equitable manner consistent with disclosure, but which may not be considered to be a pro-rata allocation. We believe that the current requirement for advisers to allocate costs and expenses among clients fairly and equitably already addresses the Commission's stated policy concerns and that the Commission has not provided meaningful evidence that the existing requirements for advisers are insufficient.

A. The proposed prohibition exceeds the Commission's statutory authority

The Release does not cite any legal authority for its stated belief that ***any*** non-pro rata allocation of fees and expenses where multiple clients invest or propose to invest in the same portfolio investment is contrary to the protection of investors. In the section of the Release discussing this proposed prohibition, the Commission cites to only one settled enforcement action and one risk alert from the Commission's Office of Compliance Inspections and Examinations.[35] However, both the enforcement action and the risk alert highlight issues related to adviser's allocating fees and expenses in a manner that was inconsistent with disclosures to investors and, as such, they do not appear to provide meaningful support for the Commission's view that any non-pro rata allocation of fees and expenses among multiple clients should be prohibited.

As discussed above, Section 211(h) was incorporated into the Advisers Act by Section 913 of Dodd-Frank, in connection with Congressional consideration of the standard of conduct for broker-dealers and a Congressional desire to address issues that may arise in the context of a broker-dealer's or investment adviser's relationship with retail customers and clients. Moreover, because the Release fails to demonstrate that any non-pro rata allocation is "contrary to the public interest and the protection of investors," this prohibition thus exceeds the statutory authority granted by Congress in Section 211(h). The Release also fails to demonstrate how allocating expenses in a non-pro rata manner in and of itself is a "sales practice, conflict of interest, or compensation scheme" within the plain meaning of Section 211(h).

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[34] Release at 16926.

[35] Risk Alert, Office of Compliance Inspections and Examinations, Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), available at: https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

B. The proposed prohibition fails to justify subjecting private fund advisers to different rules than other advisers

Similar to the proposed prohibition on charging private fund clients certain fees and expenses, the Release fails to explain why the proposed prohibition on non-pro rata allocation of fees and expenses related to a portfolio investment should apply only to private fund clients, and not to other types of advisory clients.

C. The Commission fails to conduct an adequate cost-benefit analysis in support of the proposed prohibition

i. The Proposed Rules do not adequately define key terms

The proposed prohibition does not define key terms that are fundamental to understanding the scope of the proposed prohibition, including what types of allocation methodologies would be deemed "non-pro rata" and what it means for an expense to be "related to a portfolio investment." In light of the fundamental flaws with the proposed prohibition discussed in this section, we encourage the Commission to withdraw the Proposed Rule. If the Commission does not withdraw the Propose Rule, then, at a minimum, the Commission should confirm that fees and expenses "related to a portfolio investment" are limited to costs directly and explicitly related to a specific individual investment (*e.g.*, costs of outside counsel to negotiate transaction documents for a specific investment) and do not include costs that are only generally or indirectly related to specific individual investments or that are costs of an adviser's business generally (*e.g.*, software, hardware, data feeds, research, consulting and other expert costs, or deferred compensation).

Instead of defining the term "non-pro rata," the Release discusses a very limited and simple set of examples regarding non-pro rata allocation of fees and expenses, which indicates that the Commission has not fully considered the full range of how advisers can properly allocate actual or potential investment expenses in a manner that is fair and equitable given the particular circumstances. Advisers currently allocate expenses using various methodologies, including allocation based on usage, value provided to a particular client, profits and losses, headcount, amount of time allocated, assets under management, and other methodologies. Accordingly, if the Commission does not withdraw the Proposed Rule, we encourage the Commission to confirm our interpretation that a pro rata allocation can encompass a variety of methodologies and that the use of such methodologies would therefore be permissible, provided that the applicable private fund adviser believes such methodology to be fair and equitable under the circumstances. If the Commission had in fact considered this range of methodologies, it would not (and could not) have issued the Proposed Rule with a narrow understanding of the term "non-pro rata" because prohibiting private fund advisers from selecting an allocation method that they believe fairly and equitably allocates fees and expenses among clients simply because the method does not comport with one specific and particular method of allocating costs would ultimately harm investors.

We also are concerned that, even if unintended, if the phrase "related to a portfolio investment" were interpreted broadly, it could prohibit non-pro rata allocations of expenses in a

broader set of circumstances in which other methodologies better allocate those expenses fairly and equitably among clients. This result could create risks for private fund advisers, for example, under state law to the extent that a pro rata allocation of expenses was arguably not fair and equitable and, as such, deemed to be inconsistent with the adviser's fiduciary obligations. Perhaps as a result of these oversights, the Release fails to consider less costly alternatives that could achieve the Commission's objectives.

ii. The Release does not address key unintended consequences of the proposed prohibition

To take just one relatively simple example of an instance in which an overly broad application of the Proposed Rule would harm investors, we refer to an investment adviser that uses a data feed as an input for two different forecasts that are used by different fund clients to make investments in the same issuer or issuers. The data feed may be a significant input with respect to the first forecast but a minor input with respect to the second forecast (for example, the second fund client may have subscribed to a number of additional data sources to help inform its forecast). Allocating the costs of that data feed pro rata based on the investments made by these two forecasts would be unfair to investors in a fund that is investing based on the second forecast compared to other possible allocation methodologies. In fact, pro rata allocation would result in an inappropriate subsidy by investors with exposure to the second forecast in favor of investors with exposure to the first forecast. To avoid this result, some advisers may choose, or conclude that they are required as a fiduciary, to no longer use this data feed as an input for the second forecast. As a result, such investors would be harmed by losing the benefit of that data feed simply because the adviser reasonably chose not to allocate costs that are not commensurate with the value provided by the data feed. If the Commission decides to adopt this Proposed Rule, it should confirm that these types of expenses are not subject to the prohibition, so as not to encourage advisers to ignore information they believe to be beneficial to their investment decision-making process.[36]

Moreover, there may be certain costs and expenses for which pro rata allocations (narrowly defined) may be impossible, particularly with respect to advisers to quantitative private funds or other private funds that have a high volume of trading activity. Continuing with the data feed example (though there are others), these private funds may use such feeds to create numerous forecasts and may enter into thousands of trades daily across different funds. It would not be feasible in those circumstances for an adviser to identify which data feeds and which forecasts led to specific trades for purposes of determining a pro rata allocation among funds. The Commission appears to recognize a similar issue in connection with its Proposed Rule requiring quarterly statements,[37] but it fails to account for these concerns in connection with the

[36] Such a result would be inconsistent with recent SEC staff statements regarding the importance of advisers conducting reasonable investigations into proposed investments. *See* Risk Alert, Division of Examinations, Observations from Examinations of Private Fund Advisers (Jan. 27, 2022), available at: https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf.

[37] Release at 16899 ("We recognize that certain private funds, such as quantitative and algorithmic funds and other similar funds, may have thousands of holdings and/or transactions during a quarter and that those funds typically do not receive portfolio investment compensation. While the proposed rule would not require an adviser to include any portfolio investment that did not pay or allocate portfolio-investment compensation to the adviser or its related

proposed prohibition on allocating fees and expenses on a non-pro rata basis. Finally, the proposed prohibition is likely to create significant barriers to entry for smaller and newly formed investment advisers, which advisers may have less ability to adjust their fee structures and are likely to be unable to bear the additional costs that the prohibition would impose.

iii. The Release fails to consider the economic benefits of or the costs of the proposed prohibition with respect to co-investments

Another circumstance in which advisers do, and should be permitted to, allocate fees and expenses in a fair and equitable, but non-pro rata, manner is co-investment opportunities by multiple clients or by an adviser's private fund client(s) and another investor. The Release fails to consider the benefits to investors that can result from co-investments even when one fund pays more than its pro rata share of the fees and expenses related to the co-investment.

For example, an adviser may offer an opportunity for investors to co-invest with a fund client because the adviser's ability to take a larger allocation of the investment opportunity may provide it with access to additional deals, to negotiate better terms, or arrange more favorable financing with respect to a deal than if the fund client were investing alone. Even if the other investors are not willing to pay the same costs and expenses as the fund client, the benefits to the fund client of increased investment opportunities and/or better terms on its investments can make the co-investment opportunity better than not investing in the opportunity, or investing without the benefit of co-investors. In these circumstances, the Proposed Rule's prohibition on non-pro rata allocation of fees and expenses could have the unintended consequences of reducing the investment opportunities and/or investment returns for fund clients to an extent that investors would be worse off than if the fund client were permitted to participate in the co-investment opportunity with costs and expenses not being allocated on a pro-rata basis.

We recognize that there could be circumstances involving co-investment opportunities when an adviser has an economic incentive to allocate fees and expenses on a non-pro rata basis, however, we believe that the Release fails to consider the benefits that investors can receive from non-pro rata allocations and the costs to investors if non-pro rata allocations of fees and expenses are prohibited. The Release mistakenly assumes that when an adviser co-invests alongside investors, that non pro-rata allocations are based on the adviser's economic interests. For example, the Release fails to consider that co-investment structures that include capital from an adviser (or its related persons) and investors often have different terms to accommodate specific needs of investors (*e.g.*, terms to accommodate differences in tax treatment among U.S. taxable investors, U.S. tax-exempt investors, and non-U.S. investors), not to accommodate the adviser's economic interests, and the strict prohibition would make it difficult for advisers to accommodate different investor needs and reasonably allocate the costs associated with those accommodations.

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persons during the reporting period in its quarterly statement, these advisers would need to consider how to identify such portfolio investment's payments and allocations for purposes of complying with this disclosure requirement. Should the rule provide any full or partial exceptions for such funds?").

iv. Recommendation

The proposed prohibition suffers from a number of fundamental deficiencies, including the lack of (i) statutory authority; (ii) justification for applying the proposed prohibitions only to private fund advisers; and (iii) an evidentiary record supporting the proposed prohibition and the full range of costs associated with the prohibition. Accordingly, we strongly encourage the Commission to withdraw this proposal. To the extent that the Commission does provide evidentiary support for some type of additional rulemaking in this regard, we believe that a less costly but still effective alternative to the proposed prohibition would be to require advisers to allocate costs on a fair and equitable basis and to disclose such fact to fund clients and investors.

VI. Prohibition on Preferential Treatment Regarding Liquidity Terms

Proposed Rule 211(h)(2)-3(a) would prohibit all private fund advisers from providing an investor in a private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.

We believe that the Proposed Rule is fundamentally flawed in several respects and, if adopted, would harm rather than protect investors. The Proposed Rule does not define what constitutes preferential treatment; however, the Release's discussion of preferential terms focuses on terms provided through agreements or other formal arrangements other than private fund governing documents.[38] We therefore request the Commission confirm that liquidity terms set out in the governing documents of a private fund (for example, multiple share classes that offer different redemption terms) will not be considered "preferential" terms for purposes of the Proposed Rule. Similarly, we encourage the Commission to confirm that liquidity terms in the governing documents of a substantially similar pool of assets (for example, different funds that have different liquidity terms that reflect different economic arrangements) are not subject to the proposed prohibition. In light of the discussion in the Release that focuses on side letters or other types of similar arrangements, and not provisions in the governing documents for a private fund, it appears the Commission intended to limit the scope of arrangements that are subject to the proposed prohibition to arrangements agreed to with investors outside of the four corners of a private fund's governing documents. However, uncertainty regarding the scope of the Proposed Rule may result in private fund advisers not permitting investors to choose between share classes with different redemption terms, such as a class-level gate and an investor-level gate, or different funds with different redemption terms, thus reducing investors' ability to tailor their investment to their liquidity needs. Confirming that terms set out in a private fund's governing documents is not subject to the proposed prohibition is critically important for market participants to be able to understand the scope of the proposal and its effects and also to honor the terms of governing

[38] *See, e.g.*, Release at note 187 ("The proposed rule would prohibit certain types of preferential treatment and would require an adviser to disclose other types of preferential treatment that the adviser or its related persons (acting on their own behalf and/or on behalf of the fund) provide to investors. Therefore, the proposed rule typically would apply when the adviser's related person is the general partner (or similar control person) and is a party (and/or caused the private fund to be a party, directly or indirectly) to a side letter or other arrangement with an investor, even if the adviser itself (or any related person of the adviser) is not a party to the side letter or other arrangement.").

documents already agreed to by investors and advisers. As such, to the extent the Commission adopts the proposed prohibition, we strongly encourage the Commission to confirm this interpretation in its adopting release.

This interpretation is consistent with the fact that the Release does not distinguish "preferential treatment" with respect to: (i) the proposed prohibitions on liquidity terms and portfolio information rights; and (ii) other preferential terms that must be disclosed to other investors. As investors already receive the governing documents of the private fund into which they are investing, there would not appear to be any reason for the Commission to propose a rule to require private fund advisers to provide additional disclosure regarding terms that have been set out in a private fund's governing documents.

We further request that, if the Commission decides to adopt the proposed prohibition, it confirm that the prohibition would not apply in circumstances when an investor elects to receive less liquidity than other investors (for example, in exchange for other rights or terms that are more consequential to that investor than a fund's standard liquidity terms). In such a circumstance, the investor electing to receive less liquidity would not result in material, negative effects on other investors.

A. <u>The proposed prohibition exceeds the Commission's statutory authority</u>

As discussed above with respect to a number of the Commission's proposed prohibitions, the proposed prohibition of preferential treatment regarding liquidity terms is clearly beyond the scope of activities for which Congress delegated the Commission rulemaking authority in Section 211(h). Section 211(h) was incorporated into the Advisers Act by Section 913 of Dodd-Frank, in connection with Congressional consideration of the standard of conduct for broker-dealers and a Congressional desire to address issues that may arise in the context of a broker-dealer's or investment adviser's relationship with retail customers and clients. Given that statutory intent, the Release fails to demonstrate that providing a sophisticated investor with the contractual terms it seeks in and of itself is the type of "sales practice, conflict of interest, or compensation scheme" that Section 211(h) was intended to address. Further, the Release fails to demonstrate how providing a sophisticated investor with liquidity terms that the investor itself seeks is "contrary to the public interest and the protection of investors," and the standard that would prohibit such terms when "the adviser reasonably expects to have a material, negative effect on other investors" is so vague as to be insufficient to make the prohibited conduct fit within the language of the statute. As such, the proposed prohibition exceeds the statutory authority granted by Congress in Section 211(h).

B. <u>The proposed prohibition fails to justify subjecting private fund advisers to different rules than other advisers</u>

The Proposed Rule also would capture preferential liquidity terms provided to a substantially similar pool of assets.[39] The definition creates uncertainty in several respects. First,

[39] Proposed Rule 211(h)(1)-1 defines "substantially similar pool of assets" to mean "a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects

the definition appears to potentially include funds of one as the Release says the term would include a variety of entity types, regardless of the number of investors,[40] while also indicating that the proposed prohibition would not apply to other types of advisory clients. While the Release acknowledges that similar concerns may exist in the context of separately managed accounts, the Release fails to provide a basis for applying the prohibition to a fund of one or other pooled vehicle (excluding registered investment companies), but not to other types of advisory clients.

C. The Commission fails to conduct an adequate cost-benefit analysis in support of the proposed prohibition

In light of the discussion in the Release regarding the scope of the Proposed Rule, the Release fails to provide an explanation for why private fund advisers would be permitted to include differential liquidity terms in a fund's governing documents but prohibited from providing preferential liquidity terms through side letters or other agreements with an investor. We do not believe the Commission has articulated a reasonable basis for permitting substantively similar arrangements in one type of agreement while prohibiting them in another form of agreement, both of which relate to investments in private funds.

i. The proposed prohibition establishes an overly vague standard that would be difficult to apply in practice

While the Proposed Rule only prohibits preferential redemption terms when the adviser "reasonably expects those terms to have a material, negative effect on other investors," this creates a vague standard that would be difficult for advisers to rely on as a basis for concluding *ex ante* that particular liquidity terms are not prohibited by the Proposed Rule (especially when Commission staff determinations regarding compliance with the Rule will be made after the fact and with the benefit of hindsight). Further, because the fund itself is the client of the adviser and investors in a private fund will have differing, often conflicting, interests that private fund advisers are unlikely to be fully aware of, it would be difficult, if not impossible, for an adviser to anticipate when terms might have a material, negative effect on other investors. As such, for many advisers it is likely to have the effect of causing the adviser to cease granting any such arrangements, including ordinary course terms and practices that benefit investors (as discussed further below), even if an adviser believes it is unlikely that such arrangements would have a material, negative effect on other investors (*i.e.*, if such effects are merely reasonably foreseeable). Accordingly, if the Commission is unwilling to withdraw this proposal entirely (as we would encourage it to do), we would urge the Commission to clarify that the only redemption provisions that are prohibited under this rule are ones that the adviser believes will in fact have a material negative effect and not ones where such effect is merely reasonably foreseeable.

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to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons."

[40] *See* Release at 16929.

For the reasons outlined above, the Proposed Rule is likely to reduce liquidity and to have other negative effects for investors by *de facto* prohibiting various beneficial terms and practices. For example, as noted in a question in the Release, advisers are able to provide redemption rights that accommodate the legitimate needs or legal requirements of investors, regardless of their size, with special regulatory status (*e.g.*, by providing for an involuntary redemption of an ERISA plan investor so that a fund does not breach the 25% "plan assets" threshold). We encourage the Commission to confirm that providing investors with preferential terms to meet an investor's legal requirements would not be prohibited under the Proposed Rule. In fact, many requests for such accommodations come from pension plans, making those investors among the more likely to be harmed by the proposed prohibition. Under the Proposed Rule, such investors will be precluded from investing in certain funds, subjected to further limits and the amounts of capital they are able to invest, or required to invest without the remedies, protections, or rights they have today.

In addition, the phrase "substantially similar investment policies, objectives, or strategies" is vague and potentially overly broad and could lead to advisers treating different pooled vehicles as "substantially similar pools" even when the portfolios of the pooled vehicles diverge in material respects. For example, advisers currently have the flexibility to offer investors a range of funds whose liquidity terms are well-tailored to different investors' particular investment mandates. In certain cases, the investment strategies and/or opportunities of such funds may overlap to varying degrees, while such funds nevertheless serve as distinct products offering different commercial terms. A possible consequence of the Proposed Rule, however, is that liquidity terms will converge among funds when a fund is deemed to be a "substantially similar pool of assets" relative to the other fund, thereby harming investors by being overly permissive, unnecessarily restrictive, or both. For example, if two funds are "substantially similar pools" and one has a two-year gate while the other has a three-year gate (with such terms being appropriate given differences in such funds' respective mandates), the proposal could result in the applicable adviser adopting a two-year, three-year, or two-and-a-half year gate for both funds, which would be sub-optimal for at least one if not both sets of investors. We request the Commission clarify that different pooled vehicles with different investment strategies, objectives, policies, underlying portfolios, or leverage will not be deemed to be "substantially similar pools" even if there is some overlap between the pools in respect of their portfolios (*i.e.*, substantially similar pools of assets should be substantially similar in *all* of these respects, not simply one or more of these characteristics). We also request the Commission define substantially similar pools of assets based on the different pools having identical, or substantially similar terms (such as fees) more broadly.

ii. The Release fails to adequately consider the benefits of different liquidity arrangements

The Release acknowledges that private funds and investors of all sizes derive benefits like attracting additional investors and spreading fees and expenses across a larger asset base as a result of having large investors in the private fund, even when a large investor negotiates to obtain preferential liquidity rights. The Release fails to consider, however, the broader range of benefits that investors receive from the ability to negotiate liquidity terms that meet the investor's individual needs, for example, pension mandates that require divestment from funds

that have certain investments (e.g., environmental, social, and governance mandates at the pension fund level). Further, the Release speculates about the potential harms to investors but does not provide evidence of actual investor harms as support for the need for the Proposed Rule. Finally, the proposed prohibition is likely to create significant barriers to entry for smaller and newly formed investment advisers, which will be significantly impacted by prohibitions that make it harder to initially attract anchor or seed investors.

iii. Recommendation

The proposed prohibition suffers from a number of fundamental deficiencies, including the lack of (i) statutory authority; (ii) justification for applying the proposed prohibitions only to private fund advisers; and (iii) an evidentiary record supporting the proposed prohibition and the full range of costs associated with the prohibition. Accordingly, we strongly encourage the Commission to withdraw this proposal.

iv. Additional question asked in the Release

One open question posed by the Commission in the Release is whether all preferential liquidity terms should be prohibited, rather than just those that the adviser reasonably expects to have a material, negative impact on other investors in that private fund or in a substantially similar pool of assets. The Release also asks whether all types of preferential treatment should be prohibited. Expanding the proposed prohibition would further exacerbate the issues discussed above and, accordingly, the Commission should not expand the Proposed Rule to further prohibit preferential liquidity terms or to prohibit preferential terms more broadly.

v. Technical clarification

While the heading of Proposed Rule 211(h)(2)-3 is "Preferential treatment," as drafted, the text of the Proposed Rule does not include any term or concept of preferential or disparate treatment. As a result, the Proposed Rule would appear on its face to prohibit a private fund adviser from providing an investor ***any*** ability to redeem its interest, if doing so could have a material, negative effect on other investors, not merely ***preferential*** rights to redeem its interest that could have a material, negative effect on other investors. We do not believe the Commission intended this Proposed Rule to have such a broad effect. While we strongly encourage the Commission to withdraw the Proposed Rule, if it does not do so, we urge the Commission to clarify that the rule is limited to providing an investor with ***preferential*** rights to redeem its interest.

VII. <u>Prohibition on Preferential Treatment Regarding Information Rights</u>

Proposed Rule 211(h)(2)-3(a)(2) prohibits a private fund adviser from providing an investor with:

> information regarding the portfolio holdings or exposures of the private fund, or of a substantially similar pool of assets, to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.

This proposed prohibition raises many of the same issues as the prohibition on preferential liquidity terms. In addition, this proposed prohibition is likely to have significant adverse effects on investor transparency. Large institutional investors often require specialized reporting from advisers. Advisers provide specialized reporting to investors to help meet the needs of those investors, not because the adviser is trying to preclude other investors from receiving information. For example, private fund advisers often provide holdings/exposure information to certain investors on a lag and/or to third-party risk measurement or analysis firms (*e.g.*, RiskMetrics HedgePlatform) at the request of fund investors because those investors find this information to be crucial for their own portfolio management purposes (to look at all of their outside investments in a similar manner or to look for unintended risk exposures across their entire portfolio). Other investors need specific information to meet their compliance and other obligations under state or local laws or regulations. However, while advisers may elect to subsequently provide certain of this information to all other investors, not all investors elect to receive or would even be interested in receiving this type of information. Some investors, for example, may determine that having detailed portfolio or risk information increases their obligation to independently assess the private fund's investments and are unwilling or unable to conduct such analysis. Advisers take into account these and other investor preferences in creating their investor disclosures. But because those advisers would be subject to being questioned in hindsight as to whether they should have expected a negative outcome for other investors, they likely will determine that the prudent course of action is to eliminate investor-specific reports.

While the Proposed Rule only prohibits preferential information rights when the adviser "reasonably expects that providing the information would have a material, negative effect on other investors," this creates a vague standard that would be difficult for advisers to rely on as a basis for concluding *ex ante* that particular information shared with an investor is not prohibited by the Proposed Rule. The proposed prohibition also is unclear whether it applies only to formal arrangements (through side letters or otherwise) or also would include informal communications that investors often request to have with private fund advisers. As a result, the proposed prohibition is likely to have a chilling effect on ordinary-course communications between investors and advisers.

A. <u>The proposed prohibition exceeds the Commission's statutory authority</u>

As discussed above with respect to a number of the Commission's proposed prohibitions, the proposed prohibition of preferential treatment regarding information rights is clearly beyond the scope of activities for which Congress delegated the Commission rulemaking authority in Section 211(h). Section 211(h) was incorporated into the Advisers Act by Section 913 of Dodd-Frank, in connection with Congressional consideration of the standard of conduct for broker-dealers and a Congressional desire to address issues that may arise in the context of a broker-dealer's or investment adviser's relationship with retail customers and clients.

Given that statutory intent, the Release fails to demonstrate that simply providing information about a private fund's portfolio in and of itself is a "sales practice, conflict of interest, or compensation scheme" within the plain meaning of Section 211(h). Further, the Release fails to demonstrate how providing a sophisticated investor with information that the investor seeks regarding the portfolio holdings of a private fund by itself is "contrary to the

public interest and the protection of investors," and the standard that would prohibit such terms when "the adviser reasonably expects to have a material, negative effect on other investors" is so vague as to be insufficient to make the prohibited conduct fit within the language of the statute. As such, the proposed prohibition exceeds the statutory authority granted by Congress in Section 211(h).

B. The proposed prohibition fails to justify subjecting private fund advisers to different rules than other advisers

Also similar to other provisions in the Proposed Rules that prohibit certain activities, the Commission fails to articulate why the prohibition against sharing portfolio information should only apply to private fund advisers.

C. The Commission fails to conduct an adequate cost-benefit analysis in support of the proposed prohibition

i. The proposed prohibition will harm investors by limiting information sharing and is inconsistent with the Marketing Rule

As with Proposed Rule 211(h)(2)-3(a), it is highly unlikely that disclosures of the type described in the preceding paragraph would have a material, negative effect on investors in reality. However, as drafted, the Proposed Rules will create an unnecessary disincentive to sharing information with investors. Sophisticated investors need the ability to conduct due diligence on their investments, which requires them to have the ability to ask for and receive the information they deem important to their investment decisions. The likely result of the proposed prohibition is to eliminate, or significantly reduce, the types of tailored communications that sophisticated investors seek and are able to obtain in making their investment decisions. In particular, if private fund advisers will limit or no longer accommodate these types of information requests, those investors who desire and/or rely on increased visibility into their portfolios would be needlessly harmed. This stands in stark contrast to the Commission's expressed desire to improve investors' ability to assess and compare their private fund investments with their other investments.

We further note that the Commission spent more than a year developing the recently adopted Marketing Rule to modernize the rules for private fund advisers with respect to marketing to potential and current investors. One hallmark of the new rule—in the Commission's own words—is its principles-based approach and the flexibility that it accords advisers to share valuable portfolio insights with sophisticated investors, particularly those who request specific information.[41] Notably, the Marketing Rule and the adopting release for the Marketing Rule explicitly exclude certain communications with private fund investors from the scope of the definition of "advertisement," including information provided by an adviser in response to an unsolicited request from a prospective private fund investor or that is provided to an investor in a one-on-one communication. Thus, in adopting the Marketing Rule, the Commission not only acknowledged that private fund investors often seek tailored information in their

[41] *See* Investment Adviser Marketing, *supra* note 22.

communications with private fund advisers, but also chose to promulgate a rule that facilitates those communications and tailored information sharing by reducing regulatory compliance costs that otherwise would apply to those communications. The Proposed Rule includes no explanation for the difference in approach, which is particularly troubling because the Marketing Rule took effect less than one year ago and its 18-month transition period has yet to expire.

ii. The Release fails to provide evidence of actual harm

As with other provisions in the Proposed Rules, the Release speculates about potential harms to investors that could result from certain investors negotiating for additional information rights. However, the Release does not provide evidence of actual investor harms that have resulted from a common industry practice, including harms resulting from investor use of such information. The Release also does not explain why existing industry practices, such as compliance programs that are designed to address issues related to conflicts of interest, confidentiality agreements designed to mitigate against potential harms resulting from an adviser sharing information with investors, or existing remedial authorities that the Commission has at its disposal in the event information is improperly shared and/or misused, are insufficient to address the stated concern. In the absence of such evidence, the Release does not provide a basis for prohibiting a private fund adviser from sharing tailored information with an investor that requests it. The lack of evidence is particularly noteworthy because the Proposed Rule would prohibit the kinds of information sharing with investors once they have invested in a private fund that the Marketing Rule specifically was intended to facilitate with prospective investors evaluating whether to invest in a private fund.

iii. The Release does not consider the benefits to investors of current practices or practical challenges of the proposed prohibition

Further, similar to the discussion above regarding preferential liquidity terms, the Release fails to consider that investors may be provided with preferential information rights to accommodate the legitimate needs of investors with special regulatory status (*e.g.*, by providing information to an investor that may be subject to restrictions on certain investments or subject to concentration limits in its portfolio). Under the Proposed Rule, such investors will be precluded from investing in certain funds, subjected to further limits and the amounts of capital they are able to invest, or will have to invest without the remedies, protections, or rights they have today.

The Release also fails to address the practical difficulties advisers would have in complying with the proposed prohibition, or the costs and complexities associated with such compliance. Adviser employees engage in many forms of communication with investors, including telephone and in-person conversations. The Release fails to consider the practical challenges of applying the proposed prohibitions in these and similar circumstances (for example, whether an adviser would have to preclude its employee from answering investor questions in these circumstances) or the likelihood that addressing such practical challenges will make it more difficult for investors to obtain the information they customarily seek and receive.

The Release also fails to address how the proposed prohibition could apply in practice to a proprietary vehicle that would be deemed a "substantially similar pool of assets," given that an

adviser and its related persons that owned such a vehicle would have greater access to information than third-party investors in one of the adviser's private funds. This lack of discussion further demonstrates the inadequacy of the Commission's cost-benefit analysis in the Release.

iv. Recommendation

The proposed prohibition suffers from a number of fundamental deficiencies, including the lack of (i) statutory authority; (ii) justification for applying the proposed prohibitions only to private fund advisers; and (iii) an evidentiary record supporting the proposed prohibition and the full range of costs associated with the prohibition. Accordingly, we strongly encourage the Commission to withdraw this proposal.

v. Additional question asked in the Release

Finally, the Release asks whether the proposed prohibition should be expanded to include all preferential transparency regarding holdings or exposures (regardless of the effect on other investors). Expanding the proposed prohibition would further exacerbate the issues discussed above and, accordingly, the Commission should not prohibit all preferential transparency regarding holdings or exposures.

VIII. Advance and Annual Disclosure of Other Preferential Terms

Proposed Rule 211(h)(2)-3 would require private fund advisers to provide advance disclosure regarding other preferential terms provided to investors to other current and prospective private fund investors as well as an annual disclosure requirement regarding other preferential terms provided to investors. We believe that the Proposed Rule is overly broad for two primary reasons: (i) the requirement is not subject to a materiality threshold (*i.e.*, any accommodation that is given to an investor would potentially be "preferential" if it is not also given to every other investor); and (ii) the requirement would apply not only to side letters, but to any written or unwritten accommodation that a private fund adviser may make, whether or not such accommodation is binding.

A. The proposed prohibition exceeds the Commission's statutory authority

As discussed above with respect to a number of the Commission's proposed prohibitions, the proposed requirement for private fund advisers to disclose preferential terms provided to investors to the other investors in the fund is clearly beyond the scope of activities for which Congress delegated the Commission rulemaking authority in Section 211(h). Section 211(h) was incorporated into the Advisers Act by Section 913 of Dodd-Frank, in connection with Congressional consideration of the standard of conduct for broker-dealers and a Congressional desire to address issues that may arise in the context of a broker-dealer's or investment adviser's relationship with retail customers and clients, not the negotiation or disclosure of contractual terms with sophisticated investors in private funds.

B. The proposed prohibition fails to justify subjecting private fund advisers to different rules than other advisers

Also similar to other provisions in the Proposed Rules that prohibit certain activities, the Commission fails to articulate why only private fund advisers should be required to disclose the details of their privately negotiated contractual terms with other parties.

C. The Commission fails to conduct an adequate cost-benefit analysis in support of the proposed prohibition

i. The Release does not consider the chilling effect of the proposed rule on investor communications

The overly broad scope of the Proposed Rule is likely to impede communications with investors and significantly discourage advisers from granting side letter or other investor requests that are immaterial to other investors, thereby needlessly harming investors by reducing transparency to their detriment, contrary to the Commission's objectives. It is a common practice for private fund advisers to provide side letters that accommodate investors with respect to terms are unlikely to materially affect other investors, even if technically "preferential" under the Proposed Rule, in part because such accommodations impose relatively low costs to the adviser and fund. For example, an adviser may grant an investor the right to assign its interest in the fund to an affiliate, may agree to keep an investor's information confidential, or may acknowledge certain state requirements that are relevant to public pension plans. By significantly increasing the costs and potential risks associated with an adviser agreeing to provide investors with additional rights, the Proposed Rule likely will have a chilling effect on side letters generally, particularly with respect to side letters that are important to individual investors but have no material effect on other investors.

In addition, the Proposed Rule should be expected to have a chilling effect on ordinary-course communications between investors and advisers. Currently, investors routinely ask for and receive information regarding the private funds in which they invest, including answers to general questions about risk and performance, responses to periodic due diligence questionnaires, information obtained during quarterly meetings with an adviser's staff, and updates on current events (*e.g.*, a fund's geographic exposure). To the extent that: (i) an adviser agrees with an investor in advance (whether in a side letter or otherwise) that it will provide such information; and (ii) such information is not also provided to all other investors (*i.e.*, the adviser would be agreeing to provide such investor with "preferential treatment," according to the Proposed Rules), this arrangement would be prohibited unless it was disclosed in advance to other investors. Given that private fund advisers will need to assess whether such additional information or transparency amounts to providing preferential terms, advisers may be inclined to restrict or even eliminate these types of interactions with investors going forward.

The Proposed Rule also will discourage advisers from agreeing to waivers or other ordinary-course accommodations related to fund terms. For example, provided that doing so does not adversely affect other investors, it is common practice for advisers to waive minimum subscription, withdrawal, or account size thresholds, extend contribution deadlines in capital

commitment funds, or allow investors to make or receive in-kind contributions or distributions, respectively, in private funds, depending on the strategy of the fund, among other considerations. These and other similar accommodations provide important benefits to investors; however, because of the additional costs and risks associated with such arrangements under the Proposed Rule, it is likely that many advisers will curtail them.

ii. The Release fails to provide evidence of the need for the proposed rule or evidence of actual harm

The Release also does not clearly articulate why, from a policy perspective, investors need to know the specific details of arrangements that other investors have with an adviser and why it would not be sufficient for investors to know that an adviser has agreed to preferential terms with other investors as a general matter or with respect to particular categories (such as fees or liquidity). Providing investors with less granular information would put them on notice that the adviser has agreed to other arrangements with other investors and would provide any new investor with the opportunity to negotiate the terms of its investment or decide that it is unwilling to invest in a fund when other investors have different rights. The specific terms agreed upon with investors reflect privately negotiated contracts; requiring private fund advisers to disclose the results of such negotiations to any future counterparty unfairly interferes with the right of an adviser to negotiate contractual terms. It also unfairly singles out private fund advisers from other investment advisers, which do not have to disclose to clients the terms on which they agree with other clients.

The Release does not consider the likely costs associated with the Proposed Rule. Instead, the Commission speculates that increased transparency regarding preferential terms will allow other investors to negotiate better deals with private fund advisers. For the reasons discussed above, we believe it is likely that the Proposed Rule will have the opposite effect in many cases, *i.e.*, fewer investors will be able to negotiate additional rights or receive increased transparency and substantive interactions between advisers and investors will decrease. This clearly would be a bad result for investors, with the negative effects being compounded by the retroactive nature of the Proposed Rules, which would require investors to spend resources to work with advisers to unwind existing agreements.

The Release also does not provide evidence of investor harms as the basis for the Proposed Rule. Instead, much of the discussion in the Release focuses on why the Commission believes the Proposed Rule will provide private fund investors the ability to negotiate better contractual terms with advisers. The Release does not provide evidentiary support for why it believes an investor simply knowing more information about terms other investors have negotiated will provide that investor with the ability to negotiate similar terms for itself. Indeed, we believe a more likely consequence of the Proposed Rule will be that advisers will be less willing to negotiate terms with investors, thereby decreasing, not increasing, the ability of investors to negotiate terms for their investment. For this and the other reasons discussed above, we question whether the Commission's assumptions in this regard are correct. More fundamentally, we also believe that attempting to provide sophisticated institutional and other similar investors with additional bargaining power is not an appropriate basis for Commission rulemaking.

iii. The Release fails to consider the practical challenges of the Proposed Rule

We also are concerned that the Proposed Rule is likely to present significant practical difficulties for advisers and investors from both a timing and logistical perspective. For example, advisers and investors often do not finalize terms for an investment until close to the subscription deadline. Moreover, advisers often negotiate with multiple investors at the same time, and often while simultaneously marketing to other investors. The nature of these negotiations means it often will be impractical for an adviser to provide advance written notice of preferential terms to other prospective investors as it would lead to a repeated cycle of disclosure, discussion, potential renegotiation, and further disclosure to start the cycle anew. The result would be significant costs for investors, both direct costs related to the negotiations and discussions and potentially significant opportunity and other costs if the cycle described above leads to delays in when the investor can actually invest in a private fund. With respect to annual reporting, the burdens of identifying and tracking all communications over the course of a year that could be subject to the disclosure requirement will also impose significant operational costs to be borne by investors and will create significant risk of "foot fault" violations.

iv. Recommendation

The proposed disclosure requirement suffers from a number of fundamental deficiencies, including the lack of (i) statutory authority; (ii) justification for applying the proposed requirement only to private fund advisers; and (iii) an evidentiary record supporting the proposed requirement and the full range of costs associated with the requirement. Accordingly, we strongly encourage the Commission to withdraw this proposal.

IX. Prohibition on Adviser Clawbacks Net of Taxes

Proposed Rule 211(h)(2)-1(a)(4) would prohibit an adviser from 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 likely effect of the Proposed Rule is to create a disincentive for advisers to offer clawbacks at all, to the detriment of investors. We also are concerned that the Commission may be relying on a mistaken view of the tax treatment of performance compensation and adviser clawbacks and, in particular, may have an inaccurate view of an adviser's ability to control when tax liabilities arise with respect to allocations of carried interest or the imposition of taxes on so-called "phantom income" that has not actually been received by an adviser in a particular year. We also are concerned with the Commission's treatment of a fully disclosed compensation arrangement that includes adjustments to adviser clawbacks, which is agreed to by sophisticated investors, as a *per se* violation of the Advisers Act, an assertion for which the Commission cites no legal authority.

A. The proposed prohibition exceeds the Commission's statutory authority

As discussed above with respect to a number of the Commission's proposed prohibitions, the proposed prohibition an adviser clawbacks that are net of taxes is clearly beyond the scope of activities for which Congress delegated the Commission rulemaking authority in Section 211(h). Section 211(h) was incorporated into the Advisers Act by Section 913 of Dodd-Frank, in connection with Congressional consideration of the standard of conduct for broker-dealers and a

Congressional desire to address issues that may arise in the context of a broker-dealer's or investment adviser's relationship with retail customers and clients. The Release further fails to demonstrate how an adviser clawback mechanism, which is a beneficial feature for investors, can be "contrary to the public interest and the protection of investors" simply because the clawback mechanism allocates some of the tax risk of the mechanism to investors. Given that a private fund with a clawback mechanism that provides for netting of taxes applicable to the adviser provides investors with greater rights than a private fund that does not have an adviser clawback at all, it is an overreach of the Commission's authority under Section 211(h) to prohibit clawbacks that are net of taxes simply because there exists a clawback mechanism that would be even more favorable to investors.

B. The Commission fails to conduct an adequate cost-benefit analysis in support of the proposed prohibition

We believe that the likely outcome of the Proposed Rule is that fewer advisers will agree to clawbacks, particularly with respect to hedge funds, which already are less likely to have adviser clawback mechanisms than other private funds. However, the Release does not identify or analyze the costs to investors if fewer investors were able to negotiate adviser clawbacks, or if advisers were to make other changes to performance compensation arrangements, because of the increased costs and tax risks the Proposed Rule would impose.

Further, as discussed above, we believe that the Commission may be relying on a mistaken view of the tax treatment of performance compensation and adviser clawbacks. While advisers have the ability to negotiate the economics of how performance allocations or fees will be determined, they have very limited control over the timing of tax liabilities arising from the compensation the adviser is entitled to. Under commonly utilized methodologies for allocating taxable income with respect to carried interest in funds where a clawback may be relevant, advisers generally are not able to defer the inclusion of taxable income from the carried interest until the performance compensation is actually earned or paid, or otherwise dictate the timing of taxable income inclusions (and, in fact, applicable tax rules generally seek to *prevent* deferral and a taxpayer's ability to control the timing of taxable income allocations).

In addition, advisers face significant obstacles in reversing the tax consequences of performance compensation that is paid in one year and then repaid later as a clawback.[42] As a matter of applicable tax law, advisers may not be able to amend tax returns to claim a refund for the year in which the performance compensation was initially paid (on the basis that the original taxable income allocations were proper), and such amended tax returns, if they can be filed, could also affect investors (many of whom often negotiate side letter provisions prohibiting

[42] In addition, it is common for some of the larger asset managers to share carried interest with employees via notional bonus plans. When clawbacks happen in subsequent years in a bonus plan, there is significant uncertainty under Section 1341 of the Internal Revenue Code of 1986 ("**Internal Revenue Code**") regarding the ability to claim a deduction, and participants may have to fund a clawback gross of taxes despite already being taxed at ~50% on bonus payments. Further, in certain jurisdictions outside of the United States such as the United Kingdom, there is no ability to reverse prior taxation on carried interest. Thus, this rule would force participants in these scenarios to lose money on the management of these funds, despite significant services having been rendered over the life of the fund.

amendments to prior year tax returns, unless required by law or pursuant to settlement of a tax audit). Advisers also may not be able to claim, or use, a current year tax benefit (*i.e.*, a taxable loss) that offsets the tax paid in the earlier year because the adviser may not have current year taxable income (or income of the appropriate tax character) against which to use the tax benefit (and carrying back of the tax benefit to a prior year generally is not possible). Further, due to tax rate changes, the value of the tax benefit in a subsequent year may not fully compensate for the earlier income inclusion. The consequences of the Proposed Rule may be deviations from the commonly accepted tax allocation methodologies in order to defer allocations of performance compensation to the adviser, which would accelerate allocations and taxes to investors, and an increase in the likelihood that the performance compensation will be structured as a fee (as opposed to an allocation of taxable income), which may not be deductible to certain U.S. taxable investors and which poses significant other issues for managers under the deferred compensation rules under Sections 409A and 457A of the Internal Revenue Code.

Finally, we believe that the Commission's statement that adviser clawbacks that are reduced by the adviser's tax obligation puts the adviser's interest ahead of the interest of investors is overly broad. The goal of having a net of tax clawback is to ensure that managers are not forced to return more cash than they personally received after payment of taxes. It is critical to keep in mind that clawbacks typically happen when a fund has not exceeded a specified hurdle, but it does not mean that the fund has not been profitable. So, these rules potentially end up with scenarios where the funds are profitable, but the managers are coming out of pocket to fund part of investor's returns. Every negotiation with respect to an adviser's compensation necessarily involves the adviser negotiating in its own economic interest, and advisers should not be forced to negotiate for a deal where they will lose money on the management of a fund. Accordingly, we do not believe that the Commission's statement provides a sufficient basis on which to prohibit an adviser from negotiating the economic terms of an adviser clawback, and we strongly encourage the Commission to withdraw this proposal.

X. <u>Quarterly Statements</u>

Proposed Rule 211(h)(1)-2 would require registered private fund advisers to distribute a quarterly statement to private fund investors within 45 days of the end of each calendar quarter that discloses:

> (i) detailed accounting of all fees and expenses paid by the private fund during the reporting period;
>
> (ii) fees and expenses paid by underlying portfolio companies to the adviser and its related persons; and
>
> (iii) performance information based on standardized metrics that are tied to whether the adviser classifies the fund as a liquid or illiquid fund (based on the fund's capital raising, investor withdrawal rights, investment strategy, and nature of investments).

i. The Release fails to provide evidence of actual harm

First, although the Release points to "opacity" in private markets as a basis for the proposed reporting requirements, we do not believe the Release adequately identifies actual harm from existing disclosure requirements or the insufficiency of less prescriptive disclosure requirements. As such, the Release does not provide sufficient evidence to justify the significant costs of the proposed quarterly statements. MFA supports appropriate transparency to investors and we note that private fund advisers already provide substantial amounts of information to investors, including disclosures regarding fees and expenses (such as those required for registered commodity pool operators) and audited financial statements, whether to satisfy existing regulatory requirements (such as Rule 206(4)-2 ("**Custody Rule**"), under which advisers must provide audited financial statements if they do not wish to submit to surprise examinations by auditors or to accommodate requests from investors). We further believe that the proposed reporting requirements are overly granular and will impose excessive costs on advisers without providing sufficient corresponding benefits to investors. We also are concerned that the granular reporting may raise competitive concerns for advisers because of the risk that the detailed information subsequently is disclosed beyond the adviser's investor base. As such, we encourage the Commission to adopt a more principles-based approach that is in harmony with existing Commodity Futures Trading Commission/NFA rules.

ii. The Release fails to consider the practical challenges of the Proposed Rule

Second, as a process matter, providing these statements within 45 days of each quarter-end would be a hardship and potentially even an impossibility for some private fund advisers, particularly for smaller private fund advisers. Not only would the requirement demand substantial internal resources by the adviser, it would also create undue risk of errors and reliance on preliminary estimates in such reporting. The more frequently advisers would need to provide adjusted or corrected versions of quarterly reports to investors after issuing the first version in time to meet the deadline, the less useful these reports will be to investors, who may dismiss them as unreliable and subject to change.

iii. Recommendations

If the Commission decides to adopt some form of periodic reporting, we strongly encourage the Commission to provide advisers with additional flexibility with respect to the timing and specifics of any required report by requiring such information to be disclosed with 75 days of the end of the applicable reporting period, with an additional 30 days for funds of funds, which rely on reporting from underlying funds to prepare reports for fund of funds investors. We also encourage the Commission to amend the timing of the proposed reporting requirement from quarterly to semi-annually, consistent with the timing of shareholder reports provided by registered investment companies.[43] We believe it would be illogical to require more frequent reporting to sophisticated private fund investors than is required for retail investors in registered investment companies.

[43] *See* Rule 30e-1 under the Investment Company Act.

In considering additional reporting by registered private fund advisers, we encourage the Commission to align any such requirements with the annual audited financial statements and periodic unaudited financial statements that most private fund advisers already provide to investors. Aligning any new reporting requirement with U.S. Generally Accepted Accounting Principles ("**GAAP**") (or International Financial Reporting Standards ("**IFRS**") for non-U.S. advisers to the extent they are subject to the rule) would provide private fund investors with greater consistency across the reports they receive from an adviser and would also promote comparisons across advisers, which would better accomplish the Commission's stated objective of enhancing the ability of investors to compare information.

iv. Specific comments on proposed statements

Our specific comments on the proposed quarterly statements are as follows:

A. Fund Table –

1. Many private fund managers (including commodity pool operators who are members of the NFA) already provide much of the required fee and expense disclosure quarterly on an aggregate basis. The Commission could align its reporting requirements with NFA requirements, thereby easing some of the operational burdens for investors who would otherwise need to reconcile inconsistent reports.

2. Alternatively, the Proposed Rule could be amended to provide that periodic statements should be prepared in accordance with GAAP to better align the information investors receive on these statements with the periodic and annual statements many investors already receive from private fund advisers.

3. Investment-specific expenses may be especially costly to collect (*e.g.*, for investment strategies involving very large numbers of trades across numerous trading and other counterparties), are potentially commercially sensitive, and do not implicate the conflict issues on which the Commission appears focused. Accordingly, we encourage the Commission to delete these expenses from the Fund Table.

4. The Commission also should permit advisers to aggregate expenses, with appropriate footnoting or other disclosure to explain how the adviser has aggregated expenses. Providing advisers with additional discretion on how to aggregate expenses for a periodic report will promote greater consistency between the periodic report required by the Proposed Rules and other reports that the adviser provides to investors. Prescriptive requirements for reporting expenses will cause significant practical challenges for private fund advisers, which typically have an administrator that sends reports, statements, and other information to investors. Such requirements will require administrators to use their judgment in preparing periodic statements, which could present significant challenges for advisers who will then need to monitor their administrators in preparing periodic statements for investors.

5. We also encourage the Commission to consider requiring an adviser to report expense ratios, rather than dollar amounts of particular expenses. We believe that expense ratios would provide investors with better information regarding the impact of expenses on their individual performance and the comparability of different investment products.

B. Portfolio Investment Table –

1. "Portfolio investment compensation" includes amounts paid to any "related person," which we believe is an over-inclusive standard that will yield disclosures that are at best not particularly useful and in fact potentially misleading to investors. In addition, a requirement to report such information is likely to have a chilling effect on ordinary course economic activity by creating a disincentive for advisers to operate diversifying businesses.

a. Each private fund is itself a "related person" of the adviser, so any amounts paid to a fund (*e.g.*, dividends on equity investments or interest and fees on debt investments) technically would be reportable under the rule as drafted, even though the fund's investors receive 100% of the benefit.

b. Reporting also would be required for any transactions between (i) a 25%-owned portfolio company of one private fund advised by (or any proprietary businesses of) the adviser and (ii) any issuer in which another of the adviser's private funds invests, even if such other fund owns only a single share. For example, if an adviser or a private fund it manages owns more than 25% of a software firm and that software firm provides services to an S&P 500® company that is traded by one of the advisers' other private funds, the Proposed Rule may unintentionally require reporting of such transaction.

2. We encourage the Commission to address these concerns by providing exclusions from reporting for (a) compensation received by the private fund directly (as opposed to the adviser), (b) transactions involving a public company and/or a company that the adviser does not control, and (c) ordinary course arm's length transactions.

C. Performance –

1. The Marketing Rule, which was developed over more than a year after lengthy fact-finding by the Commission and deeply substantive discussions with both investors and advisers, has a compliance date of November 2022. Many advisers are currently in the process of updating their policies and procedures with respect to investor communications that include performance information. The Commission has not provided any evidence to demonstrate that the requirements and prohibitions established by the Marketing Rule are insufficient to protect investors or prospective investors in private funds and that the additional

performance reporting requirements in the Proposed Rule (or the prohibitions on providing of certain information to investors, which would cut directly against the aims of transparency and full disclosure emphasized in the Marketing Rule release) are necessary.

2. In addition, we believe that the Proposed Rule would require the provision of metrics that investors are not likely to find useful, such as fund-wide performance for vehicles in which no investor actually experiences such performance. Many funds offer different types of interests to accommodate the needs of different investors, and each such interest will experience different returns; for example, funds may offer new issues and restricted series, classes with different fee terms (such as management fee-only or fee and carry options), or currency classes for non-U.S. investors. Investors expect and need reporting on the returns that their accounts actually experience; the one-size-fits-all metrics required by the Proposed Rule would only obscure this information. Further, even if advisers voluntarily incur the additional cost of providing corrective or clarifying information, the Proposed Rule will create material risk of investor confusion and private litigation by investors. In our members' experience, investors often find it unhelpful and confusing to receive multiple sets of performance returns that are computed differently.

a. These costs and risks will be exacerbated for advisers that have committed to providing alternative performance reporting standards, as an accommodation to certain investors, such as GIPS, which establish opt-in performance reporting standards that many pension and other institutional investors demand. Advisers may be forced to abandon GIPS reporting and compliance due to a lack of sufficient internal resources to devote to anything beyond the proposed SEC regime. This would be a notable loss and costly adverse consequence for investors who have built their portfolio monitoring and evaluation systems around the performance and attribution reporting they currently receive from most if not all of the advisers with whom they invest.

3. The Release asks whether the Proposed Rule should provide required performance metrics on the basis of whether a private fund is liquid or illiquid, or whether the definitions of liquid and illiquid fund should be deleted and provide advisers with discretion to provide the proposed metrics that the adviser believes most accurately portray the fund's returns. We believe that the binary distinction between liquid and illiquid funds is not well suited to the wide range of private funds, which can combine elements of both types of funds. We believe that providing advisers with additional discretion in reporting performance metrics would be preferable and would be more likely to lead to investors receiving more meaningful information.

D. Cross References –

We encourage the Commission to remove the requirement for advisers to produce separate, additional disclosures regarding investor statements or cross-reference specific sections of fund organizational and offering documents, which likely would impose a costly burden on advisers, particularly with respect to disclosure items that are relevant to multiple funds. This requirement also could create significant risk of "foot fault" violations by advisers, and we believe those costs and risks are not justified by any benefit to investors.

XI. Borrowings

Proposed Rule 211(h)(2)-1(a)(7) would prohibit a private fund adviser from, directly or indirectly, borrowing money, securities, or other private fund assets, or receiving a loan or an extension of credit, from a private fund client. We are concerned that without additional clarification from the Commission, the inclusion of the phrase "or indirectly" in the Proposed Rule could impair the ability of advisers to manage their funds efficiently. Private fund terms often permit advisers to take advances against their share of the fund's assets, including the accrued performance fees or "carry" that the adviser maintains in the fund, for legitimate operating purposes, including to pay tax obligations and to fund employee compensation (*e.g.*, when a payroll provider requires pre-funding but the relevant amounts are invested in the fund in the form of deferred compensation balances or incentive allocations). Moreover, these advances present little risk to investors because the amounts advanced are significantly over-collateralized.

In our experience, such advances materially benefit investors by: (i) preventing premature assets sales by funds needing to raise cash for legitimate business purposes; and (ii) further encouraging alignment of interests among investors and the adviser's investment staff by exposing such staff's deferred compensation to the fund's returns. These benefits are particularly important for smaller and newly formed investment advisers that may have a greater need for the flexibility provided by such arrangements. As such, we believe that the proposed prohibition is likely to have a disproportionate adverse effect on, and to create significant barriers to entry for, smaller and newly formed investment advisers, which advisers may have less ability to increase their management or similar fees to meet their operational needs. These factors act to limit investor choices and potentially impede other efforts by the Commission and President Biden's administration to promote greater diversity within the asset management industry.

XII. Grandfathering and Transition Relief

For the reasons discussed above, we believe that the Commission has not provided evidentiary support for a number of the Proposed Rules and has not conducted a sufficient economic analysis of the likely costs associated with the Proposed Rules. Further, the Commission has not articulated a basis for imposing restrictions only on private fund advisers, while permitting advisers to other types of clients to continue engaging in similar activities. Finally, we believe that several of the Proposed Rules would impose restrictions that go beyond the Commission's authority under the Advisers Act and Section 211(h) in particular. As such, we encourage the Commission to withdraw the Proposed Rules until such time as the agency can address these fundamental concerns.

To the extent that the Commission nonetheless decides to move forward in finalizing any of the Proposed Rules, we strongly encourage the Commission to provide both grandfathering of existing arrangements and a sufficient transition period that reflects the time that would be required to implement such sweeping changes. With respect to grandfathering of existing relationships and agreements, we note that many of the proposed changes likely will require advisers to renegotiate agreements with investors, a process that will require investor cooperation and, as such, is not entirely in the adviser's control. In light of the practical challenges associated with getting investor consent to renegotiate existing agreements (which, in many cases, could require investors to agree to give up rights for which they previously negotiated), the Commission should apply any final rules only on a going forward basis and not apply any final rules to existing agreements or arrangements as of the date of any final rule.

Advisers also will need to update their compliance policies given the updates to the books and records rule and the annual certification, implement changes to how private fund advisers compute their track records (including existing track records), and reprogram existing software or obtain new software for tracking and reporting of expenses. Any final rules also should provide for a transition period of not less than 24 months to provide advisers time to develop policies and procedures to comply with any final rules and systems to implement those policies and procedures.

XIII. Audited Financial Statements

As the Release notes, many private fund advisers already provide audited financial statements to investors annually for purposes of complying with the Custody Rule. The Division of Investment Management has provided guidance under the Custody Rule regarding investment special purpose vehicles ("**SPVs**"), pursuant to which advisers may treat the assets of an SPV as assets of a pooled investment vehicle client, subject to certain conditions (such as the assets of the SPV being included in the audit of the client fund and the SPV being wholly owned by the fund client, the adviser, or the adviser's related persons).[44] If the Commission adopts final rules requiring registered private fund advisers to cause each private fund client to undergo an annual audit, it should confirm that audits that comply with the Custody Rule and are distributed to all private fund investors will be deemed to satisfy the requirements of Rule 206(4)-10 (a)-(d). We further encourage the Commission to consider other situations in which the audit requirement should not apply, for example, when an adviser elects to undergo a surprise audit under the Custody Rule, during stub periods, or when a private fund that holds a single asset is winding down.

XIV. Prohibition on Fees for Services Not Provided

Proposed Rule 211(h)(2)-1(a)(1) would prohibit a private fund adviser from charging a portfolio investment for fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment. We are concerned that the broad prohibition could create unintended consequences for advisers that contract to provide

[44] *See* Division of Investment Management Guidance Update No. 2014-07 (June 2014), available at https://www.sec.gov/investment/im-guidance-2014-07.pdf.

services when those services are discontinued in the future before completion. For example, an adviser may be retained by a portfolio investment to provide information technology services in building out a customer database for the portfolio investment. To the extent the portfolio investment decides for business or other reasons not to complete that work, a broad interpretation, applied in hindsight, could deem some or all of the payments for those services to be prohibited. While the Release cites potential conflicts of interest as the basis for this prohibition, it does not cite evidence that such arrangements have harmed investors nor does the Release articulate why full and fair disclosure of potential conflicts of interest would be insufficient to permit sophisticated investors to protect themselves in deciding whether to invest in private fund that includes such arrangements.

XV. Adviser-Led Secondaries

Proposed Rule 211(h)(2)-2(a)(1) would prohibit a registered investment adviser from completing an adviser-led secondary transaction with respect to any private fund unless the adviser obtains and distributes to the private fund investors a fairness opinion from an independent opinion provider. We believe that this proposed requirement will simply increase costs for investors in connection with such transactions. The sophisticated investors involved in these transactions can, and already do, require the information with respect to the terms of a transaction (for example, the involvement of a third-party valuation firm) that those investors deem necessary. Requiring a fairness opinion when sophisticated investors have concluded that the costs associated with such an opinion are not justified will serve to harm investors, not protect them.

The Release also asks whether the Commission should require fairness opinions in other contexts, for example certain cross transactions involving private funds. In that regard, we believe that, if the requirement were made applicable to all cross-trades, it would (i) discourage beneficial cross-trades in favor of higher-cost alternatives; (ii) be unnecessary in many cases (*e.g.*, for level 1 and 2 assets); and (iii) be very costly for investors (particularly for relatively small cross-trades). We also note that there are numerous alternatives to a fairness opinion that private fund advisers can and frequently do rely on to ensure that the interests of investors are protected (*e.g.*, independent agent consent, auctions, third-party valuations, and various other compliance policies and procedures relating to the mitigation of conflicts of interest).

XVI. Responses to Additional Questions in the Release

The Release seeks comment on several questions related to an adviser's compensation, including: (i) a possible ban on 2 and 20 performance compensation; (ii) a possible cap on management fees; (iii) a possible ban on "American waterfalls" that calculate performance compensation on a deal-by-deal basis; and (iv) a proposal to address performance-based compensation for open-end private funds. The Commission should not engage in setting compensation limits for advisers and private funds. Rate setting goes well beyond the scope of Section 211 and would go further than the Investment Company Act provisions related to the approval of management agreements.

Private fund advisers structure their fees to provide sufficient resources to manage their advisory business and structure their performance compensation to provide the opportunity to generate profits for the firm in a manner that aligns the interest of the adviser with the interest of investors. Given the wide range of business models and investment strategies, it is critical that private fund advisers have flexibility in structuring their compensation arrangements. Banning or restricting particular types of management fees and performance compensation arrangements, or the use of such fees or arrangements generally, would fundamentally disrupt the private funds industry and the alignment of interests on which it is based.

Placing a cap on management fees also would have a number of unintended consequences. An adviser's management fee provides it with a reasonably reliable stream of revenue to pay for the costs associated with running its business. Those costs vary significantly from firm to firm and from year to year. Accordingly, imposing such caps could be both extremely disruptive to private fund advisers' ability to manage their costs and spend the resources they believe appropriate (including compliance and operational costs) to operate their business as well as highly destabilizing for such advisers and the funds they manage. This could have significant adverse consequences on investors.

The use of so-called "American waterfalls" helps ensure that both investors in a fund and the general partner of the fund can receive distributions during the operation of the fund, which can reduce the risk for managers associated with operating for long periods of time without generating revenue. Because funds structured with this type of distribution typically provide a clawback feature designed to ensure that the total performance compensation paid to the fund's general partner does not exceed the amount set out in the fund's offering documents, investors are protected from overpayment risk. The distribution schedule reflects a negotiated agreement between sophisticated investors and private fund advisers that is designed to address the business needs of the adviser and protect the investor from overpayment of performance compensation.

As stated above, the performance compensation in private funds is intended to align the interests of the private fund adviser and investors in the fund. This alignment of interest provides valuable benefits to investors. Given the wide range of fund strategies, investor liquidity rights, and nature of fund assets and a common desire for managers to further align the interests of the adviser and investors through compensation of adviser employees that relates to the performance compensation, it is critical for advisers to have flexibility in structuring their performance compensation. Prescriptive rules related to compensation arrangements are likely to have significant unintended consequences and are likely to disrupt the alignment of interests that advisers and investors seek to achieve through their negotiation of economic terms.

Accordingly, we strongly encourage the Commission not to consider restrictions on the form or amount of compensation that advisers and private fund investors are permitted to agree to through contractual negotiations.

* * *

XVII. Conclusion

MFA appreciates the opportunity to provide comments to the Commission on the Proposed Rules. We welcome the opportunity to discuss our views with you in greater detail. Please do not hesitate to contact Matthew Daigler, Vice President & Senior Counsel, or the undersigned, at [redacted], with any questions that you, your respective staffs, or the Commission staff might have regarding this letter.

Very truly yours,

/S/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Allison Herren Lee, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner
Mr. William Birdthistle, Director, Division of Investment Management

Appendix A

The SEC's Proposed Rules for Private Fund Advisers

Craig M. Lewis, Ph.D.*

April 25, 2022

The SEC's Proposed Rules for Private Fund Advisers

Craig M. Lewis, Ph.D.*

April 25, 2022

* I am the Madison S. Wigginton Professor of Finance and Professor of Law at Vanderbilt University. From June 2011 to May 2014, I was Chief Economist and Director of the Division of Economic and Risk Analysis at the U.S. Securities and Exchange Commission.

Table of Contents

I. Introduction

1. I was commissioned by Managed Funds Association ("MFA") to assess the soundness of the economic analysis included in the Commission's proposed Rules for Private Fund Advisers: Documentation of Registered Investment Adviser Compliance Reviews, which was published in the Federal Register as part of the Commission's Release No. IA-5955 on March 24, 2022 ("Proposal" or "Proposed Rules"). Specifically, I compare the Commission's analysis to what is required by statute or otherwise acknowledged by the Commission as a practice it follows to maintain consistency with executive orders on regulatory economic analysis.

2. I find that the Commission has not shown an unmet investor need as a motivation for the Proposal, nor has it adequately demonstrated that investors would benefit. I also find that the Commission has not fully considered the costs of the Proposal and has omitted discussion of entire categories of potential new costs. Rather than lowering fees, the Proposal is likely to disproportionately reduce the ability of smaller funds to compete and, in turn, harm investors. Lastly, I find that the SEC's Proposal neglects to consider reasonable alternatives that could address the SEC's purported concerns but would be less burdensome to implement.

II. Overview of Relevant Portions of the Private Funds Proposal

3. The Proposal targets new regulations for the activities of private fund advisers. Although the Commission has previously pursued enforcement action against certain individual private fund advisers for their lack of compliance with existing legal obligations and related matters, it maintains that "these activities [evidencing lack of compliance] persist."[1] Accordingly, the Commission proposes a number of additional rules for all private funds. These proposals are outlined in detail below.

4. The Proposal would prohibit certain activities by the investment adviser, including "charging certain fees and expenses to a private fund or portfolio investment," reducing the amount of adviser clawback by the amount of certain taxes, seeking indemnification or other

[1] "Private Fund Advisers; Documentation of Registered Adviser Compliance Reviews," Securities and Exchange Commission, 17 CFR Part 275, Release Nos. IA-5955; File No. S7-03-22, March 24, 2022, available at https://www.sec.gov/rules/proposed/2022/ia-5955.pdf ("Proposal or Proposed Rules"), p. 9.

limitation of liability by the private fund or its investors for a breach of fiduciary duty and related matters, and borrowing money, securities, or other assets from a client.[2]

5. The Proposal sets forth specific prohibitions on preferential treatment. The release states, "we also propose to prohibit all private fund advisers, regardless of whether they are registered with the Commission, from providing preferential terms to certain investors regarding redemption or information about portfolio holdings or exposures."[3] Other types of preferential treatment would also be prohibited "unless the adviser provides written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons are providing to other investors in the same fund."[4]

6. The Proposal "would require an investment adviser that is registered or required to be registered with the Commission to prepare a quarterly statement that includes certain information regarding fees, expenses, and performance for any private fund that it advises and distribute the quarterly statement to the private fund's investors within 45 days after each calendar quarter end, unless a quarterly statement that complies with the Proposed Rules is prepared and distributed by another person."[5]

7. The quarterly statement disclosures would require advisers to include "certain information regarding fees and expenses, including fees and expenses paid by underlying portfolio investments to the adviser or its related persons."[6] These disclosures would include information about adviser compensation, fund expenses (other than adviser compensation), and any amount of offsets or rebates carried forward during the reporting period.[7] Adviser compensation would include "all compensation, fees, and other amounts allocated or paid to the investment adviser."[8] Fund expenses would include "separate line items for each category of fee or expense reflecting the total dollar amount."[9] The Proposal would also require portfolio investment-level disclosure covering all investments "in which the private fund has invested

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[2] Proposed Rules, pp. 133–134.
[3] Proposed Rules, p. 162.
[4] Proposed Rules, p. 162.
[5] Proposed Rules, pp. 17–18.
[6] Proposed Rules, p. 24.
[7] Proposed Rules, p. 27–28.
[8] Proposed Rules, p. 28.
[9] Proposed Rules, pp. 30–31.

directly or indirectly."[10] For all amounts presented, the proposed quarterly statement rule "would require each statement to include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated."[11]

8. Advisers would also be required to "include standardized fund performance information" in each quarterly statement for investors.[12] Advisers would need to include "prominent disclosure of the criteria used and assumptions made in calculating the performance."[13] In the Proposed Rules, the SEC lists specific metrics that would need to be included for liquid and illiquid funds.[14]

9. The Proposal also would "require private fund advisers to obtain an annual audit of the financial statements of the private funds they manage."[15] The audit would need to be prepared in compliance with U.S. GAAP.[16]

10. Finally, the Proposal would "require an adviser to obtain a fairness opinion in connection with certain adviser-led secondary transactions where an adviser offers fund investors the option to sell their interests in the private fund, or to exchange them for new interests in another vehicle advised by the adviser."[17]

11. The SEC proposes a one-year transition period following the rules' effective dates.[18]

III. Economic Analysis of the Private Funds Proposal

12. The "Current Guidance on Economic Analysis in SEC Rulemakings" ("Guidance") articulates the SEC's approach to conducting high-quality economic analysis in rulemakings.[19] It contains four substantive components that must be addressed:

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[10] Proposed Rules, pp. 40–41.
[11] Proposed Rules, p. 53.
[12] Proposed Rules, pp. 55.
[13] Proposed Rules, p. 83.
[14] Proposed Rules, p. 63–67.
[15] Proposed Rules, p. 99.
[16] Proposed Rules, p. 106.
[17] Proposed Rules, p. 121–122.
[18] Proposed Rules, p. 182.
[19] Memorandum Re: "Current Guidance on Economic Analysis in SEC Rulemakings," Division of Risk, Strategy and Financial Innovation (RSFI) and the Office of the General Counsel (OGC), Securities and Exchange Commission, March 16, 2012, available at https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf ("Guidance on Economic Analysis in Rulemakings"), p. 1.

i. the clear identification of a need for the rulemaking—the so-called "market failure"— and an explanation of how the proposed rule will meet that need;[20]
ii. the characterization of an appropriate economic baseline against which to measure the proposed rule's likely economic impact ("in terms of potential benefits and costs, including effects on efficiency, competition and capital formation in the market(s) the rule would affect");[21]
iii. the identification and evaluation of reasonable alternatives to the proposed regulatory approach;[22] and
iv. an assessment of the potential economic impact of the proposed rule and reasonable alternatives "by seeking and considering the best available evidence of the likely quantitative and qualitative cost and benefits of each."[23]

13. In addition, the SEC has a statutory obligation to evaluate the impacts of its rulemaking on several broad economic factors, including efficiency, competition and capital formation.[24] These provisions impose on the SEC a "'statutory obligation to determine as best it can the economic implications of the rule,'" and caution that failure to do so may result in a finding that the rule is "arbitrary and capricious."[25]

14. In this section, I discuss the various provisions in the Proposal and evaluate whether the economic analysis conforms with the four substantive components of the Guidance.

A. The SEC Does Not Provide Sufficient Evidence of a Market Failure or an Unmet Investor Need as Motivation for the Private Funds Proposal

15. The Guidance lists a number of potential justifications for rules the Commission chooses to propose. These include responding to market failures that market participants cannot solve, such as "market power, externalities, principal agent-problems… and asymmetric information."[26] The Guidance lists other potential justifications which include "improving government processes, interpreting provisions in statutes the Commission administers, and providing exemptive relief from statutory prohibitions."[27]

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[20] Guidance on Economic Analysis in Rulemakings, p. 5.
[21] Guidance on Economic Analysis in Rulemakings, p. 1.
[22] Guidance on Economic Analysis in Rulemakings, p. 1.
[23] Guidance on Economic Analysis in Rulemakings, p. 1–2.
[24] Guidance on Economic Analysis in Rulemakings, p. 2–3.
[25] Guidance on Economic Analysis in Rulemakings, p. 3 (internal citations omitted).
[26] Guidance on Economic Analysis in Rulemakings, p. 5.
[27] Guidance on Economic Analysis in Rulemakings, p. 5–6.

The Commission asserts that the Proposal will result in a number of benefits:[28]

> "*In analyzing the effects of the [P]roposed [R]ules, we recognize that investors may benefit from access to more useful information about the fees, expenses, and performance of private funds. They also may benefit from more intensive monitoring of funds and fund advisers by third parties, including auditors and persons who prepare assessments of secondary transactions. Finally, investors may benefit from the prohibition of certain sales practices, conflicts of interest, and compensation schemes that result in investor harm. We recognize that the specific provisions of the [P]roposed [R]ules would benefit investors through each of these basic effects*."

1. The Enforcement Cases Cited by the Commission are Inadequate to Support the Proposed Rules' Supposed Benefits

16. To support these claims, the Proposal cites to a number of enforcement cases dating back over a decade that demonstrate situations where the Commission pursued wrongdoing against private funds. By definition, enforcement actions involve conduct that the SEC already has the authority to regulate. These cases provide weak justification for the Proposal because they either predate the significant regulations recently required by the Dodd-Frank Act and amendments to Form PF, or the Commission failed to obtain an admission of wrongdoing.

17. The Commission cites to instances of alleged inappropriate conduct that occurred prior to the enactment of the Dodd-Frank Act and amendments to Form PF in 2011.[29] Of the thirteen unique cases cited in the "Background and Need for Reform" section of the Proposal, eight concern conduct that either partially or wholly predates the enactment of these regulations.[30] Further, it is not unusual for the SEC to bring hundreds of enforcement action in a given year—from 2011–2021, the SEC filed 8,424 total enforcement actions.[31] Against this backdrop,

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[28] Proposed Rules, p. 216.

[29] Proposed Rules, p. 7, citing to "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF," Securities and Exchange Commission, 17 CFR Part 4, Release No. IA-3308; File No. S7-05-11, October 31, 2011, available at https://www.sec.gov/rules/final/2011/ia-3308.pdf ("2011 Form PF Adopting Release").

[30] These cases include the following matters: *In the Matter of Kohlberg Kravis Roberts & Co. L.P.*; *In the Matter of Blackstone Management Partners L.L.C.*; *In the Matter of NB Alternatives Advisers, LLC*; *In the Matter of Global Infrastructure Management LLC*; *SEC v. Phillip A. Falcone, et al.*; *In the Matter of Bluecrest Capital Management Limited*; *SEC v. Joseph W. Daniel*; *In the Matter of Joseph W. Daniel*; *In the Matter of Lincolnshire Management, Inc.*

[31] "SEC Announces Enforcement Results for FY 2021," Securities and Exchange Commission, November 18, 2021, available at https://www.sec.gov/news/press-release/2021-238; "2020 Annual Report," Securities and Exchange Commission, November 2, 2020, p. 14, available at https://www.sec.gov/files/enforcement-annual-report-2020.pdf; "SEC Enforcement Activity Against Public Company Defendants," Fiscal Years 2010–2015, Cornerstone Research, p. 3, available at https://online.wsj.com/public/resources/documents/2016_0109_sec_companies.pdf.

thirteen enforcement actions represent less than 0.2% of the total enforcement actions filed over the last decade. This percentage would be even smaller if measured from the start of the earliest action.

18. If prior enforcement actions were to provide sufficient support to establish a market failure, one would expect to observe admissions of wrongdoing, particularly given the SEC's criteria for obtaining such admissions. In September 2013, then-SEC Chair Mary Jo White announced that the SEC would require admissions of wrongdoing in cases where there was "a special need for public accountability and acceptance of responsibility."[32] In particular, Chair White identified four categories of enforcement circumstances in which admissions might be appropriate:

a. Cases where a large number of investors have been harmed or the conduct was otherwise egregious.
b. Cases where the conduct posed a significant risk to the market or investors.
c. Cases where admissions would aid investors in deciding whether to deal with a particular party in the future; and
d. Cases where reciting unambiguous facts would send an important message to the market about a particular case.[33]

19. A review of the cases cited in the Proposal indicates that of 13 cases cited in the "Background and Need for Reform" section, only one settlement included an admission of wrongdoing.[34] Since the Commission apparently did not believe that the conduct posed a significant risk to the market or investors, or harmed a large number of investors, it is disingenuous to use these cases as justification for additional rulemaking. These enforcement actions also illustrate that the Commission already has the authority to challenge the types of behavior identified in these cases. Notwithstanding that the Commission has coupled this

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[32] Mary Jo White, Chair, "Deploying the Full Enforcement Arsenal," Securities and Exchange Commission, September 26, 2013, available at https://www.sec.gov/news/speech/spch092613mjw.
[33] Mary Jo White, Chair, "Deploying the Full Enforcement Arsenal," Securities and Exchange Commission, September 26, 2013, available at https://www.sec.gov/news/speech/spch092613mjw.
[34] Proposed Rules, fn. 12, citing to the matter *Securities and Exchange Commission v. Philip A. Falcone, Harbinger Capital Partners Offshore Manager, L.L.C. and Harbinger Capital Partners Special Situations GP, L.L.C., Civil Action No. 12 Civ. 5027 (PAC) (S.D.N.Y.) and Securities and Exchange Commission v. and (sic) Harbinger Capital Partners LLC, Philip A. Falcone and Peter A. Jenson, Civil Action No. 12 Civ. 5028 (PAC) (S.D.N.Y.), Civil Action No. 12 Civ. 5027 (PAC) (S.D.N.Y.).*

authority with a small number of anecdotal examples, it has failed to establish a reasonable basis for the numerous new proposed regulations.

2. The Growth in Private Funds Demonstrates a Lack of Evidence of a Market Failure

20. The growth in private funds over the years is direct evidence that the existing regime has provided an effective mechanism for channeling investor capital to companies and improving stock market efficiency. Academic literature has found that hedge funds contribute to efficiency of equity prices more than other types of institutional investors such as mutual funds or banks.[35] Given the role of private equity funds and venture capital funds in providing financing for non-public companies, including smaller and start-up companies, the efficiency of the regulatory regime for these funds can have a direct effect on the capital formation process. Rather than producing benefits as the Commissions asserts in the Proposal, the regulations are more likely to impose unnecessary costs. Unnecessary restrictions on private funds will make these channels less efficient and on the margin will likely have a deleterious impact on capital formation. This is why if the Commission is considering rulemaking in this area, it must carefully consider whether there is any evidence of a market failure that is preventing efficient capital formation through the private fund channel and, if so, whether the Proposed Rules would help ameliorate the market failure.

21. In fact, evidence suggests that the private funds market has evolved over time, in part due to the demands of investors. Private equity funds have diversified their investments and hedge funds have shifted their asset allocations. For example, CalPERS stated in 2009 that "it would no longer invest in hedge funds in which manager compensation was perceived as a misaligning incentive."[36] The evolution in the strategies of private investment funds reflects a market in which participants are sensitive to investors' preferences and demands.

22. Data also suggest that the private funds industry has grown in size while delivering quality services to investors, and as discussed below, coinciding with a reduction in fees. As

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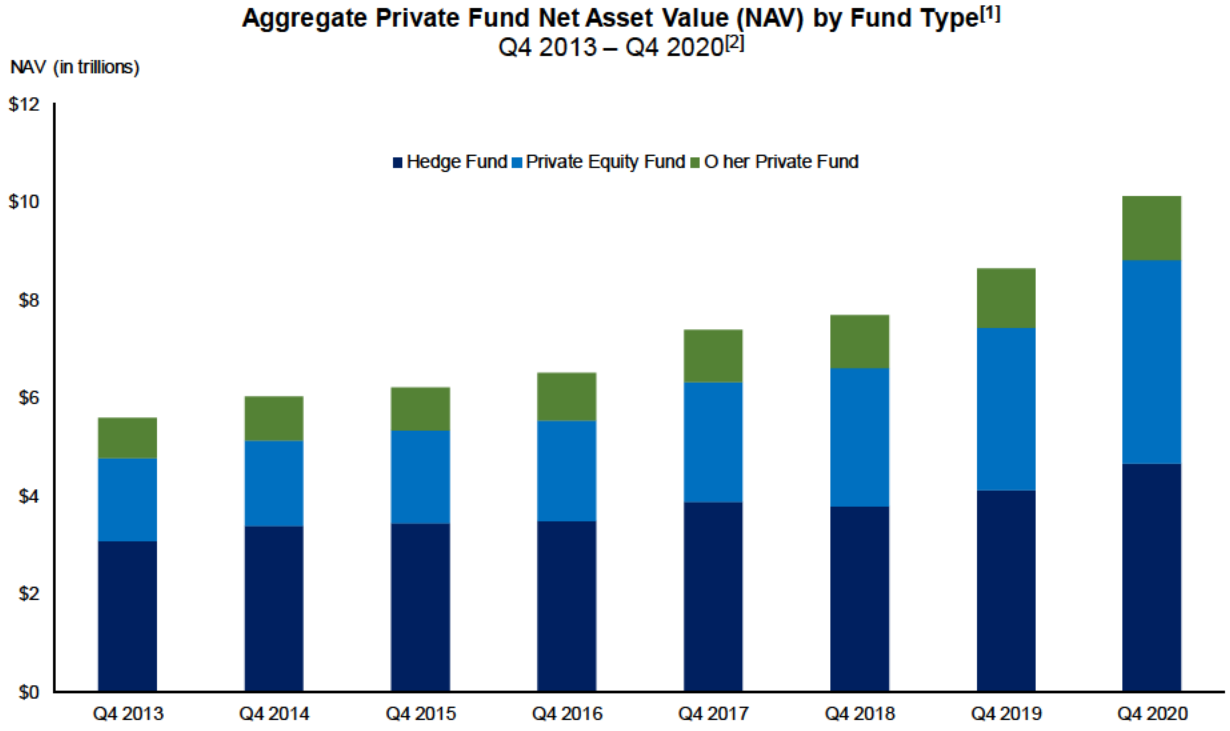
[35] The authors note that the hedge fund ownership effect can be negative during liquidity crises. *See* Charles Cao et al., "Hedge Fund Holdings and Stock Market Efficiency," *Review of Asset Pricing Studies, Forthcoming*, June 14, 2016 (Revised April 20, 2017), pp. 1–63 at 39–40, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2793513.

[36] Houman B. Shadab, "Hedge Fund Governance," *Stanford Journal of Law, Business, and Finance* 19 (1), 2013, pp. 143–204 at 175.

shown in Figure 1, from 2013 to 2021, the private funds industry in aggregate saw an increase in net asset value (NAV) of over $6.5 trillion.[37]

Figure 1



Source: Private Funds Statistics, Division of Investment Management, Risk and Examinations Office, Securities and Exchange Commission, 2014–2020, available at https://www sec.gov/divisions/investment/private-funds-statistics.shtml.

Note:
[1] The fund categories in this analysis are a subset of those included in the SEC's *Private Fund Statistics* report, and represent the largest three categories by net asset value excluding subcategories of hedge funds and private equity funds.
[2] The SEC defines the fourth quarter to include reports filed from November 15th of a given year to February 15th of the following year.

23. With this growth has also come impressive returns to private fund investors. The HFRI 500 Index "consist[s] of the largest 500 funds that report to the [Hedge Fund Research] Database, are open to new investments and offer quarterly liquidity or better. The indices are equal weighted and rebalanced on a quarterly basis." The top decile of HFRI 500 index constituents returned an annual average of 45.1 percent in returns to investors.[38] Investors also reported high levels of satisfaction with their hedge fund allocations – 80% said they believe

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[37] *Private Funds Statistics: Fourth Calendar Quarter 2014,* Division of Investment Management, Risk and Examinations Office, Securities and Exchange Commission, December 30, 2015, p. 5; *Private Funds Statistics: Second Calendar Quarter 2021,* Division of Investment Management, Analytics Office, Securities and Exchange Commission, January 14, 2022, p. 5.
[38] *See* "HFRI 500 Hedge Fund Index Methodology," available at https://www hfr.com/hfri-500-index-methodology; Hedge Fund Research, "New hedge fund launches rise as industry capital surpasses historic milestone," March 25, 2022, available at https://www hfr.com/news/new-hedge-fund-launches-rise-as-industry-capital-surpasses-historic-milestone#:~:text=CHICAGO%2C%20(March%2025%2C%202022,in%20the%20indexation%2C%20analysis%20and.

their portfolio risk would increase without hedge funds.[39] Similarly, Bain reports that "[b]uyout funds on average have generated stronger pooled net IRR than public markets across multiple time periods," and the gap has widened over time.[40] A survey conducted by Preqin in 2021 revealed investors' apparent satisfaction with their private equity allocations: 95% of respondents reported that the performance of their private equity portfolio met or exceeded their expectations in the past year.[41]

24. Despite the industry's growth and high performance, fee percentages paid by investors in hedge funds have actually declined over time. Hedge Fund Research ("HFR") reports that the "average industry-wide management fee [for a hedge fund] decreased by one basis point from 1.37 percent to 1.36 percent over the year, while the average incentive fee declined from 16.35 percent to 16.1 percent in 2021. Both estimated fees represent the lowest level since HFR began publishing these estimates in 2008."[42] In that timeframe, average management fees have fallen from 1.55 percent to 1.36 percent, while incentive fees have fallen from 19.25 percent to 16.07 percent, demonstrating the dynamics in a highly competitive marketplace.[43] In fact, academic literature cited by the SEC in the Proposed Rules also concludes "investors consistently select or are offered the best fee structure in their respective funds, at least in terms of ex-post performance."[44] These data suggest that investors are able to extract value from their investments, and that competitive market forces already allow for reduced fees without the need for additional regulation.

B. The Commission Does Not Establish an Adequate Economic Baseline

25. Closely related with the need to identify and fully characterize the justification for rulemaking, the Commission is required to characterize the economic baseline against which to

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[39] Managed Funds Association, "The Role of Alternative Investments in Today's Capital Markets," April 8, 2018, p. 5, available at https://www.managedfunds.org/research/the-role-of-alternative-investments-in-todays-capital-markets/.
[40] Bain & Company, "The Private Equity Market in 2021: The Allure of Growth," March 7, 2022, p. 24, available at https://www.bain.com/insights/private-equity-market-in-2021-global-private-equity-report-2022/.
[41] Bain & Company, "The Private Equity Market in 2021: The Allure of Growth," March 2022, p. 25, available at https://www.bain.com/insights/private-equity-market-in-2021-global-private-equity-report-2022/.
[42] Hedge Fund Research, "New hedge fund launches rise as industry capital surpasses historic milestone," March 25, 2022, available at https://www hfr.com/news/new-hedge-fund-launches-rise-as-industry-capital-surpasses-historic-milestone#:~:text=CHICAGO%2C%20(March%2025%2C%202022,in%20the%20indexation%2C%20analysis%20and.
[43] Hedge Fund Research, "HFR Microstructure Hedge Fund Industry Report – Year End 2021," March 25, 2022, p. 65.
[44] Proposed Rules, fn. 196, citing to Juliane Begenau and Emil Siriwardane, "How Do Private Equity Fees Vary Across Public Pensions?", Harvard Business School Working Paper, No. 20-073, January 2020 (Revised March 2022), p. 4.

measure the impact of their Proposed Rules. The Guidance establishes that the economic baseline should characterize a baseline for all market participants:[45]

> "*In articulating the appropriate economic baseline for a rulemaking, rulewriting staff should work with the [DERA] economists to describe the state of the world in the absence of the proposed rule, including the existing state of efficiency, competition, and capital formation, against which to measure the likely impact of the proposed rule and the principal alternative regulatory approaches. It is important to clearly describe the assumptions that underlie the description of the relevant baseline and to detail those aspects of the baseline specification that are uncertain. Defining the baseline typically involves identifying and describing the market(s) and participants affected by the proposed rule. Most SEC rules affect one or more markets directly but it may also be appropriate to consider additional markets or participants that may be indirectly affected by the proposed rule*."

26. The Proposal provides very little discussion of the baseline. It briefly summarizes the size of the industry and the trends in private fund growth over the past five years, and references abstract examples of arrangements in which private fund advisers engaged in behaviors that conflict with the Proposed Rules, such as charging fees for services that are not performed. While this type of broad summary information should be included in the baseline discussion, it does little to advance the public's understanding of how the market functions and the types and frequency of arrangements that exist between private funds and their investors.[46]

27. In addition, the baseline discussion does not adequately detail relevant regulatory gaps arising from the existing regime, and, more importantly, why the current regulations are inadequate to protect sophisticated investors. In certain sections of the Proposal, the Commission even acknowledges that advisers generally follow elements of the Proposed Rules, such as providing investors with quarterly reporting, obtaining annual audits, and certain recordkeeping practices.[47] However, the Proposal would also impose substantial new

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[45] Guidance on Economic Analysis in Rulemakings, p. 7.

[46] Proposed Rules, p. 185. In fact, as noted below, the SEC admits that it "is unable to quantify certain economic effects because it lacks the information necessary to provide estimates or ranges of costs."

[47] For example, the Commission concedes that "[w]e recognize that many advisers already provide audited financial statements to fund investors in connection with the adviser's alternative compliance with the custody rule." Proposed Rules, p. 254. *See also* Proposed Rules, p. 154 ("We recognize that many advisers do not charge all their clients or potential co-investors for fees and expenses relating to unconsummated investments."); Proposed Rules, p. 250 ("We recognize that many advisers already provide

requirements on private fund managers—requirements that reflect a fundamental change in the regulatory framework.

28. In recent years, the SEC has adopted several regulations that have impacted investment advisers. For example, in 2011 the SEC adopted amendments to the Investment Adviser Act pursuant to the Dodd-Frank Act.[48] Previously, advisers to private funds were exempt from registration requirements if they had fewer than 15 clients, where a fund was counted as one client. Among other things, the Dodd-Frank Act Amendments eliminated this private adviser exemption, thereby requiring that these investors be subject to the same registration requirements and oversight as other SEC-registered investment advisers.[49] The SEC also amended Form ADV in 2010 to adopt new disclosure requirements for investment advisers, and adopted new reporting requirements on Form PF in 2011 for certain advisers to hedge funds and other funds.[50] In 2019, the SEC released the "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" to "reaffirm—and in some instances clarify—certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act."[51] Further, throughout this period the SEC's Division of Examinations issued risk alerts highlighting issues concerning investment advisers identified by the Office of Compliance Inspections and Examinations.[52] However, the Commission has not fully evaluated the impact of these recent rules and whether they are sufficient to bring enforcement actions in the areas the SEC is trying to address with the Proposal.

29. In contrast to their cited justifications in the Proposal, prior SEC rulemaking acknowledges that the benefits of additional disclosure do not always outweigh the costs. For example, in Release No. IA-3308 entitled "Reporting by Investment Advisers to Private Funds

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audited fund financial statements to fund investors in connection with the adviser's alternative compliance with the custody rule.").

[48] *See* "Rules Implementing Amendments to the Investment Advisers Act of 1940," Securities and Exchange Commission, 17 CFR Parts 275 and 279, Release No. IA-3221; File No. S7-36-10, September 19, 2011, available at https://www.sec.gov/rules/final/2011/ia-3221.pdf ("Investment Advisers Act Amendments").

[49] *See* "SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act," Securities and Exchange Commission, June 22, 2011, available at https://www.sec.gov/news/press/2011/2011-133 htm#:~:text=Washington%2C%20D.C.%2C%20June%2022%2C,and%20reallocate%20regulatory%20responsibility%20for.

[50] *See* Investment Advisers Act Amendments; "Amendments to Form ADV," Securities and Exchange Commission, 17 CFR Parts 275 and 279, Release No. IA-3060; File No. S7-10-00, 75 FR 49233, August 12, 2010, available at https://www federalregister.gov/documents/2010/08/12/2010-19617/amendments-to-form-adv; 2011 Form PF Adopting Release.

[51] *See* "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," Securities and Exchange Commission, 17 CFR Part 276, Release No. IA-5248; File No. S7-07-18, effective July 12, 2019, pp. 3–4.

[52] *See e.g.,* risk alerts enumerated at https://www.sec.gov/exams.

and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF," the Commission specifically noted the costs and alternatives of requiring advisers to disclose more standardized information to help regulators.[53] Ultimately, the Commission concluded: "Obtaining more standardized information from more advisers more often and more quickly would likely improve the value of the Form PF data to FSOC and other regulators, and several commenters supported alternatives along one or more of these dimensions. The Commissions are concerned, however, that the costs of such changes may, in general, increase more quickly than the benefits."[54] The same logic applies to these Proposed Rules. Although disclosure of more standardized information would likely help regulators, the Commission has not demonstrated that the benefits to investors and regulators outweigh the costs suffered by advisers and, ultimately, their investors.

30. The Proposal also characterizes certain proposed requirements as an already existing "best practice" for the private funds industry without providing empirical evidence that they are in fact widely used by private funds.[55] Based on discussions with industry experts, current best practices include annual audits.[56] By contrast, proposed requirements like required disclosures, a prohibition on indemnification, and fairness opinions cannot be characterized as current best practice. Rather, they reflect aspirational requirements the Commission believes should be made available to all fund investors regardless of whether they actually need such assurances, the cost of which will be passed through to investors in the form of higher fees.

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[53] 2011 Form PF Adopting Release.

[54] 2011 Form PF Adopting Release, p. 144.

[55] Proposed Rules, fn. 247 ("Additionally, although advisers are not required to deliver the Form ADV Part 2A brochure to private fund investors, many private fund advisers choose to provide the brochure to investors as a best practice."). *See also* Proposed Rules, p.125 ("certain advisers obtain fairness opinions as a matter of best practice.")

[56] Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, Managed Funds Association, to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, "Re: Proposed Rule on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (RIN: 3235-AN07; Release No. IA-5955; File No. S7-03-22)," April 25, 2022 ("MFA Comment Letter"), Section XI.

C. The Commission Does Not Provide Evidence that the Private Funds Proposal Will Result in the Purported Benefits nor Does It Adequately Consider All Potential Categories of Costs

31. The Guidance provides specific criteria for what constitutes a rigorous evaluation of the benefits and costs of a proposed rule. According to the Guidance, an economic analysis should:[57]

> *"(1) identify and describe the most likely economic benefits and costs of the proposed rule and alternatives; (2) quantify those expected benefits and costs to the extent possible; (3) for those elements of benefits and costs that are quantified, identify the source or method of quantification and discuss any uncertainties underlying the estimates; and (4) for those elements that are not quantified, explain why they cannot be quantified*."

Below, I analyze the Proposal in the context of this criteria.

1. The Proposed Rules Do Not Adequately Consider the Costs of Prohibition on Preferential Treatment

32. According to the SEC's guidance on rule-making, the economic efficiency benefits of a rule may consist of reduced incentive misalignment/reduced monitoring costs, lower cost of capital, reduced transition costs, better information sharing, and others.[58] However, the SEC has not shown the Proposed Rules will offer these efficiency benefits without increasing the costs involved.

33. To illustrate this point, consider the Proposal's prohibition on preferential treatment where the Commission asserts:[59]

> *"[I]nvestors may not have information regarding the preferred terms granted to certain investors (e.g., seed investors, strategic investors, those with large commitments, and employees, friends, and family). Advisers frequently grant preferred terms to certain investors that often are not attainable for smaller institutional investors or individual investors. In some cases, these terms materially disadvantage other investors in the private fund."*

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[57] Guidance on Economic Analysis in Rulemakings, pp. 9–10.
[58] Guidance on Economic Analysis in Rulemakings, pp. 10–11.
[59] Proposed Rules, p. 11.

34. The SEC appears to be adapting a "one-size-fits-all" paradigm with this aspect of the Proposal. The Proposed Rules would in many instances override negotiated contract provisions and would fundamentally change the nature of how the private fund industry operates. However, even public markets in which retail investors invest, do not operate with this same level of uniformity. For example, firms use a wide variety of contracting arrangements when designing their capital structures, such as senior debt, convertible debt, and subordinate debt.[60] Senior debt-holders are provided preferential treatment in bankruptcy relative to existing debt.[61] The specific terms of these deals are opaque to shareholders as shareholders only learn of significant changes after these arrangements have been made, and even then, they are not privy to all details of the arrangements.[62] While public issuers are required to make regular periodic disclosures (in Forms 10-Q and 10-K), these filings do not disclose all of the complexities associated with different aspects of firms' capital structures.[63]

35. By imposing a "one-size-fits-all" approach, the SEC has not considered that the Proposed Rules will not affect all investors beneficially, and will likely even harm certain investors. Different investors with different preferences and regulatory constraints may care about different dimensions of the advisory contract and their position vis-à-vis the fund.[64] These different dimensions may include fees, access to information about the portfolio, information enabling them to perform due diligence or monitor the adviser, being involved in advisory committees,

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[60] In an analysis of a random sample of firms with an issuer credit rating, it was observed that the "grand majority of firms in the sample simultaneously use more than one type of debt financing." Joshua D. Rauh and Amir Sufi, "Capital Structure and Debt Structure," *The Review of Financial Studies* 23(12), December 2010, pp. 42–43.

[61] David Kravitz, "The Outer Fringes of Chapter 11: Nonconsenting Senior Lenders' Rights Under Subordination Agreements in Bankruptcy," *Michigan Law Review* 91(2), 1992, pp. 281–317 at 284 ("The basic concept behind subordinated debt is simple: the subordinated creditor agrees that under certain circumstances, the claims of specified senior creditors must be paid in full before any payment may be made to, and retained by, the subordinated creditor.").

[62] Financial disclosures are often too complex for investors to interpret the information, and to utilize the information for trading decisions. *See* Brian P. Miller, 2010, "The Effects of Reporting Complexity on Small and Large Investor Trading," *The Accounting Review* 85(6), November 2010, pp. 2107–2143 at 2108 ("[M]ore complex reports are associated with lower levels of aggregate trading volume; and the relationship between report complexity and trade activity appears to be driven by a reduction in small investor trade volume."); Judson Caskey, Kanyuan Huang, and Daniel Saavedra, "Noncompliance with SEC regulations: evidence from timely loan disclosures," Review of Accounting Studies, September 22, 2021, Section 2.2 ("[T]he SEC requires that firms file a Form 8-K disclosure within four business days of entering into a material debt contract…The borrower can, however, request that the SEC allow it to redact proprietary information contained within the contract. By redacting data, firms are able to avoid disclosing information that they deem proprietary, thereby reducing the overall amount of information that is disclosed to the public.").

[63] For example, firms in the United States only report the net of pension assets and pension liabilities instead of reporting both funded and unfunded pension liabilities. Raghuram G. Rajan and Luigi Zingales, "What Do We Know about Capital Structure? Some Evidence from International Data," *The Journal of Finance* 50(5), December 1995, pp.1421–1460 at 1426, 1434.

[64] For example, a seed investor might still be subject to the terms of a lock-up period, while an ordinary investor could withdraw their funds. *See* Christian-Oliver Ewald and Hai Zhang, "Hedge fund seeding via fees-for-seed swaps under idiosyncratic risk," *Journal of Economic Dynamics & Control* 71, August 5, 2016, pp. 45–59 at 46.

having transfer rights, liquidation rights, timing of investor withdrawals, and others.[65] Investors in mutual funds similarly choose among share classes depending on a variety of individual factors. For example, one investor may choose to pay the front-end sales charge imposed by Class A shares to benefit over time from their relatively low annual fees. Another investor might choose Class C shares despite their higher annual expenses, due to their lack of front-end sales charges and their relatively short window of time (compared to Class B) during which a back-end sales charge applies.[66] Providing a particular investor "preferential treatment" along these dimensions does not necessarily disadvantage other investors. In fact, this type of preferential treatment potentially increases costs for the adviser. For example, some funds might allow large investors to interview the portfolio managers, or to examine the fund's current portfolio, which may involve the time and attention of portfolio managers, or provide customized reports. These are all examples of "preferential treatment" that the SEC is proposing to prohibit, although this prohibition would not benefit all investors.

36. Under the current regime, funds can negotiate the terms of the advisory contract with each investor, allowing each investor to optimize the contracts in ways that reflect what each investor values the most. In the same negotiation, the adviser can consider cost in deciding what "preferential treatment" it is willing to offer. Based on well-established principles of economics, allowing such free contracting generally allows for more efficient allocations, because the contracts will reflect the dimensions each investor cares about (barring specific types of market failure, none of which the release has articulated). Imposing restrictions on the flexibility of the adviser to give differential treatment to different investors almost certainly reduces economic efficiency.

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[65] Michael F.E. Akkawi, Amy C. Johnson-Spina, Shannon Gotfrit, and Batya Nadler, "Hot Topics in Private Fund Negotiations," Torys, available at https://www.torys.com/Our%20Latest%20Thinking/Publications//2017/01/hot-topics-in-private-fund-negotiations/ ("Investors "want access to investment opportunities, insight into sponsors' strategies and business plans, and transparency and disclosure that reflects the long-term nature of their relationships with sponsors," and "The list of fees and expenses that offset a sponsor's management fee is significant to investors, who want to understand how fees will be allocated among the sponsors various investment vehicles and any carve-outs."); *See also* Osborne Clarke, "The liquidation preference clause in venture capital transactions," April 24, 2018, available at https://www.osborneclarke.com/insights/the-liquidation-preference-clause-in-venture-capital-transactions ("The liquidation preference clause is of particular importance in the frame of venture capital transactions, because it determines the return that each investor will receive upon an exit of the company."); *See also* Christopher Gardner, Nathalie Sadler, Mikhaelle Schiappacasse, and David A. Vaughan, "Private fund side letters: common terms, themes and practical considerations," *JDSupra*, September 2018, available at https://www.jdsupra.com/legalnews/private-fund-side-letters-common-terms-45939/ ("Transferability is particularly important to certain investors, for example certain German pension funds, who may need to be able to demonstrate free transferability (or as near to free transferability as the fund can practically offer) for regulatory reasons.").

[66] FINRA, "Mutual Funds: Share Classes," available at https://www finra.org/investors/learn-to-invest/types-investments/investment-funds/mutual-funds/share-classes.

37. In this sense, the Proposed Rules interfere with the rights of advisers and clients to shape the nature of their relationship through contractual provisions. The SEC has failed to establish that preferential treatment allowing separate negotiation of fees and expenses could not be adequately requested by investors and disclosed accordingly. Instead, the Proposed Rules may harm investors by limiting certain investment opportunities due to the inability to structure different fee arrangements. I note that the SEC has recently loosened protections for retail investors with certain rulemakings such as the JOBS Act, and also allowed more investors to be defined as "accredited investors" that may invest in private capital markets.[67] This is at odds with the type of protections proposed in these Proposed Rules.

38. The prohibitions of preferential terms will harm investors who currently benefit from bespoke terms. The specific terms agreed to are included in privately negotiated contracts and the Commission has not demonstrated why private fund investors should be given the specific contractual arrangements of other investors. Requiring private fund advisers to disclose the specific terms they have agreed to with a particular investor unfairly interferes with the right of an adviser to negotiate economic terms with investors and unfairly singles out private fund advisers from other investment advisers, which do not have to disclose to other clients the economic terms they agree to with one client. Moreover, I note the Proposed Rules do not include any discussion indicating that existing arrangements would not be affected. This would cause disruption and reduce economic efficiency for pre-existing investor and adviser relationships.

39. Additionally, the prohibition of preferential terms will harm investors that have the ability to provide access to capital that may not be available if preferential treatment is prohibited. There are valid reasons an adviser may offer more favorable terms to a particular investor.[68] For example, seed investors provide funds when the cost of capital is higher than it

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[67] "SEC Adopts Amendments to Implement JOBS Act and FAST Act Changes for Exchange Act Registration Requirements," Securities and Exchange Commission, May 3, 2016, available at https://www.sec.gov/news/pressrelease/2016-81 html; Jay Clayton, Chairman, "Statement on Modernization of the Accredited Investor Definition," Securities and Exchange Commission, August 26, 2020, available at https://www.sec.gov/news/public-statement/clayton-accredited-investor-2020-08-26.

[68] Christian-Oliver Ewald and Hai Zhang, "Hedge fund seeding via fees-for-seed swaps under idiosyncratic risk," *Journal of Economic Dynamics & Control* 71, August 5, 2016, pp. 45–59 at 46 ("This is an arrangement to which we refer as fees-for-seed swap that specifies that a seed investor (or seeder) commonly commits to providing a remarkable amount of seed capital to an ESFs manager as an 'anchor investor' in a new fund in exchange for a share of 'enhanced economics' which is usually the fees that the ESFs manager generates from the entire pool of assets in the fund. If structured properly, the seeding approach can be highly beneficial to the ESFs manager and to investors who provide the seed capital. It is not uncommon that the hedge fund seeder receives a portion of the hedge fund's revenue stream to get greater return potential than an ordinary investor.").

would be for subsequent investors that provide funding after the investment manager has established a successful track record. For this reason, investors that provide seed capital generally take on greater risk, and thus may want lower fees and/or more information with their investment.[69] In turn, seed investment helps start a new business venture and, if successful, subsequently benefits all future investors by creating an additional investment opportunity, which has the additional benefit of enhancing capital formation in the market.

40. Another important aspect of the private funds market which is undiscussed in the Proposal is that larger investors have strong incentives to actively monitor and communicate with their investment manager. This type of fund governance benefits all investors. The limitation on certain types of preferential treatment will likely result in weaker fund governance that cannot be replaced by quarterly disclosures to investors due to an inherent free-rider problem that is created when all investors have the same legal status.[70] Due to the limits on preferential treatment, all investors will have equal, or no incentive, to monitor their investments.

41. In addition, the SEC's Division of Examinations is not subject to the same limitations as investors, whom the Proposed Rules purport to be helping. The Division of Examinations can request information about a fund's or adviser's financial statements whenever desired. Therefore, it is unnecessary and inefficient to place a costly burden on funds to regularly automatically report additional information to the SEC.

2. The Proposed Rules Will Likely Disadvantage Small Fund Advisers

42. The Proposed Rules will have a negative impact on competition, which will likely disproportionately affect small fund advisers. For example, the Proposed Rules claim that

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[69] Christian-Oliver Ewald and Hai Zhang, "Hedge fund seeding via fees-for-seed swaps under idiosyncratic risk," *Journal of Economic Dynamics & Control* 71, August 5, 2016, pp. 45–59 at 56–57; *see also* "What Are Investors Looking For? Size and Track Record Requirements," *Preqin*, March 2014, available at https://docs.preqin.com/newsletters/hf/Preqin_HFSL_Mar_14_Investor_Preferences_Size_Track_Record.pdf ("Investors are becoming more demanding when selecting hedge fund managers and, as a result, they want to see a significant track record before investing…The most common minimum track record requirement is three years, with 45% of investors having this policy.")

[70] Andrei Shleifer and Robert W. Vishny, "A Survey of Corporate Governance", *The Journal of Finance* 52(2), 1997, pp.737–783 at 754. ("The most direct way to align cash flow and control rights of outside investors is to concentrate share holdings. This can mean that one or several investors in the firm have substantial minority ownership stakes, such as 10 or 20 percent. A substantial minority shareholder has the incentive to collect information and monitor the management, thereby avoiding the traditional free rider problem"); "Free riding occurs when one firm (or individual) benefits from the actions and efforts of another without paying or sharing the costs," *See* OECD, "Glossary of Statistical Terms," March 5, 2003, available at https://stats.oecd.org/glossary/detail.asp?ID=3222, accessed April 21, 2022.

providing standardized disclosures may increase competition by reducing search costs and facilitating easier comparison for investors.[71] But such hypothesized benefits are suspect, for many reasons. For one, investors can already obtain such information by requesting it from advisers. Moreover, the proposed new regulations will have a compliance cost and an overhead operational cost that must be borne by all advisers, but for large advisers that already have a robust compliance apparatus in place, the marginal cost will likely be smaller as a percentage of assets under management.[72] Higher regulatory costs raise the fixed costs of being a private fund adviser and thus increase the threshold scale at which a fund can be viable.[73] In other words, increasing regulatory costs will likely induce some advisers to exit the industry, decreasing the number of advisers and increasing the barriers to entry.[74] Thus, the proposed new regulations may have an adverse impact on competition, and particularly on the ability of smaller advisers to compete.

43. The Proposal does not adequately address the possibility that these costs will likely disproportionately affect smaller start-up funds, many of whom are likely minority-led advisers. Not only will the Proposed Rules make it harder to attract seed investors but it will require a larger initial capital outlay. A 2021 industry report indicates that non-diverse-owned hedge funds are more than double the size of diverse-owned funds.[75] The average non-diverse-owned hedge fund size is $338 million in AUM, whereas women-owned and minority-owned funds

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[71] Proposed Rules, p. 12. ("Enhanced information about costs, performance, and preferential treatment, would help an investor better decide whether to invest or to remain invested in a particular private fund, how to invest other assets in the investor's portfolio, and whether to invest in private funds managed by the adviser or its related persons in the future. More standardized information would improve comparability among private funds with similar characteristics... this information would help investors better understand marketplace dynamics and potentially improve efficiency for future investments, for example, by expediting the process for reviewing and negotiating fees and expenses.")

[72] MFA Comment Letter, Section V. C.

[73] Christian-Oliver Ewald and Hai Zhang, "Hedge fund seeding via fees-for-seed swaps under idiosyncratic risk," *Journal of Economic Dynamics & Control* 71, 2016, pp. 45–59 at 45, 56. ("…most capital providers or institutional investors increasingly focus on larger established hedge funds whose assets under management (AUM) are usually larger than 1 billion… Worse still, barriers to entry for ESFs are much higher today than in the period before the 2008 financial crisis."; "As traditional approaches to attract the initial AUM and covering of organizational expenses becomes much harder for ESFs managers in a much tighter financial landscape…"); "Launch bad: Breaking into the hedge-fund world is harder than before," The Economist, April 2013, available at https://www.economist.com/finance-and-economics/2013/04/20/launch-bad. ("Gone are the days when two traders with a Bloomberg terminal and some banking contacts could brand themselves as a hedge fund and attract outside money, says Kent Clark of Goldman Sachs Asset Management, the bank's investment arm. Paying for all this box-ticking requires more like $100m in assets.").

[74] MFA Comment Letter, Section V. C.

[75] Knight Foundation and Bella Private Markets, "Knight Diversity of Asset Managers Research Series: Industry," 2021, p.12, available at https://knightfoundation.org/wp-content/uploads/2021/12/KDAM_Industry_2021.pdf.

hold $132 million and $124 million in AUM, respectively.[76] The changes in the Proposal will make it harder for these women-owned and minority-owned funds to gain traction and compete due to the larger initial capital outlay.

44. The Commission states: "Certain fund advisers may also face costs in the form of declining revenue, declining in compensation to fund personnel and a potential resulting loss of employees, or losses of investor capital. However, some of these costs, such as declining compensation to fund personnel, would be a transfer to investors depending on the fund's economic arrangement with the adviser."[77] The Commission has not considered that while large funds may be able to absorb these costs, such costs are likely to more significantly impact smaller funds. The Commission also acknowledges that reduced revenues, and in turn reduced compensation for advisers, may make entities less competitive as employers.[78] This is again more likely to impact smaller funds, as they may have fewer other sources of revenue to cover this shortfall.

45. Additionally, the Proposal dismisses the large initial capital outlay that adhering to the Proposed Rules would require and does not show that the benefits of this regulation would outweigh the costs. The Commission admits that many of the proposed changes would have a high initial cost to implement but does not consider the magnitude of this cost and how it may disproportionately affect some advisers more than others. For example, the Commission notes that "[d]isclosures of such preferential treatment would impose direct costs on advisers to update their contracting and disclosure practices to bring them into compliance with the new requirements, including by incurring costs for legal services. These direct costs may be particularly high in the short term to the extent that advisers re-negotiate, re-structure and/or revise certain existing deals or existing economic arrangements in response to this prohibition."[79] Similarly, the Commission acknowledges that requiring an annual audit with a PCAOB-registered accounting firm for the entire industry may lead to an increase in the cost of obtaining an audit, but does not show that the benefit of this would outweigh the costs.[80]

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[76] Knight Foundation and Bella Private Markets, "Knight Diversity of Asset Managers Research Series: Industry," 2021, p.12, available at https://knightfoundation.org/wp-content/uploads/2021/12/KDAM_Industry_2021.pdf.
[77] Proposed Rules, p. 218.
[78] Proposed Rules, p. 227.
[79] Proposed Rules, p. 248.
[80] Proposed Rules, p. 257.

3. The Proposed Rules Do Not Consider the Sophistication of Private Fund Investors

46. The Commission fails to consider that sophisticated investors invest in private funds and does not establish that sophisticated investors need the purported protections outlined in the Proposal. Investors in private funds also have evolved over time in terms of their preferences. As investors become more "sophisticated," they increasingly seek more specialized investments.[81] This demand for specialized investments reflects that private fund investors are able to distinguish between different investment vehicles and choose the best investment for their needs. Moreover, these sophisticated investors have an obligation to themselves, or in a fiduciary capacity, to become informed about any contracting arrangements between the fund and other investors.

47. Additionally, recent SEC Guidance amending the definition of an Accredited Investor was already intended to ensure only sophisticated investors would qualify to invest in these types of holdings. In that rule, the SEC noted, "[t]he amendments are intended to update and improve the definition to identify more effectively investors that have sufficient knowledge and expertise to participate in investment opportunities that do not have the rigorous disclosure and procedural requirements, and related investor protections, provided by registration under the Securities Act of 1933."[82] Similarly, in defining a Qualified Institutional Buyer, the SEC stated the definition is intended to "identify a class of investors that can be conclusively assumed to be sophisticated and in little need of the protections afforded by the Securities Act's registration provisions."[83] For defining both Accredited Investors and Qualified Institutional Buyers, the SEC remarked the final rules "ensure that these entities have sufficient financial sophistication to participate in investment opportunities that do not have the additional protections provided by registration under the Securities Act."[84]

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[81] Bain & Company, "The Private Equity Market in 2021: The Allure of Growth," March 7, 2022, p. 5, available at https://www.bain.com/insights/private-equity-market-in-2021-global-private-equity-report-2022/.
[82] "Accredited Investor Definition," Securities and Exchange Commission, 17 CFR Parts 230, 240, Release Nos. 33-10824; 34-89669; File No. S7-25-19, December 8, 2020, Section I, available at https://www.sec.gov/rules/final/2020/33-10824.pdf
[83] "Accredited Investor Definition," Securities and Exchange Commission, 17 CFR Parts 230, 240, Release Nos. 33-10824; 34-89669; File No. S7-25-19, December 8, 2020, Section I, available at https://www.sec.gov/rules/final/2020/33-10824.pdf
[84] "Accredited Investor Definition," Securities and Exchange Commission, 17 CFR Parts 230, 240, Release Nos. 33-10824; 34-89669; File No. S7-25-19, December 8, 2020, Section I, available at https://www.sec.gov/rules/final/2020/33-10824.pdf

48. The Commission has not established why the investments of sophisticated investors should be subject to more stringent disclosure standards. The Proposal provides the following justification for the new mandated disclosure requirements for fees and expenses:[85]

> "[*W*]*e continue to observe that private fund investments are often opaque; advisers frequently do not provide investors with sufficiently detailed information about private fund investments. Without sufficiently clear, comparable information, even sophisticated investors would be unable to protect their interests or make sound investment decisions. For example, some investors do not have sufficient information regarding private fund or portfolio company fees and expenses to make informed investment decisions, given those fees and expenses can be subject to complicated calculation methodologies (that often include the application of offsets, waivers, and other limits); may have varied labels across private funds; and can affect individual investors' returns differently because of alternative fee arrangements set forth in side letter agreements*."

49. The proposed changes require additional disclosures which could limit incentives for investors to monitor fund advisers. Although private fund advisers would be required to disclose significantly more information, "more" disclosure is not necessarily "better" disclosure. Shadab (2013) finds "if investor-friendly governance devices are improperly structured or taken too far, investors run the risk of undermining the unique performance based incentives and other governance mechanisms that enable hedge funds to produce superior returns in the first place. Importantly, investors may benefit from less disclosure, higher fees, and less access to their capital."[86] In particular, Shadab notes "[s]ophisticated hedge fund investors already have well-defined preferences regarding what information and level of transparency they seek."[87]

50. Without providing any empirical evidence, the Commission's implicit presumption is that private funds are unwilling to provide detailed fee and expense information to investors who otherwise would have no ability to obtain this information. This argument fails to consider the possibility that an investor who is willing to commit capital to a fund can ask the fund for this information. If the fund is unresponsive or the investor still does not understand the fee

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[85] Proposed Rules, pp. 9–10.

[86] Houman B. Shadab, "Hedge Fund Governance," *Stanford Journal of Law, Business, and Finance* 19 (1), 2013, pp. 143–204 at 151. *See also* Sergio Beretta and Saverio Bozzolan, "Quality Versus Quantity: The Case of Forward-Looking Disclosure," *Journal of Accounting, Auditing and Finance* 23(3), 2008, p. 333–376 at 371. ("[R]ichness and quantity of disclosure are two independent dimensions and reveal that quantity is not a good proxy for quality in assessing narrative disclosure.")

[87] Houman B. Shadab, "Hedge Fund Governance," *Stanford Journal of Law, Business, and Finance* 19 (1), 2013, pp. 143–204 at 197.

structure, the solution is for the investor to invest elsewhere. The fact that private market solutions are not already established suggests that these considerations are of second-order importance.

4. The Proposed Rules Do Not Consider the Negative Effects of the Higher Standard of Care Imposed by the Proposal

51. The Commission's justification for the new standard of care is as follows:[88]

> *"[O]ur staff [] has encountered instances where advisers seek to limit their fiduciary duty or otherwise provide that the adviser and its related persons will not be liable to the private fund or investors for breaching its duties (including fiduciary duties) or liabilities (that exist at law or in equity). We believe an adviser that seeks to limit its liability in such a manner harms the private fund (and, by extension, the private fund investors) by putting the adviser's interests ahead of the interests of its private fund client*."

52. The Commission has not demonstrated a market failure with respect to the ban on exculpation and indemnification outlined in the Proposal. This market is populated by sophisticated investors who are able to contract on their own behalf. Exculpation and indemnification provisions are standard in private fund agreements.[89] As a matter of custom and practice, and as a negotiated term among the parties, it is common for private funds to exculpate and indemnify their advisers for losses other than those caused by the applicable adviser gross negligence or willful misconduct.[90] The parties have thus determined how best to allocate losses and liabilities between them. This allocation is fundamental to the economics of the private funds industry.

53. Whereas the current standard of care protects fund managers from routine second-guessing, the change to the higher standard included in the Proposal will substantially increase costs, such as insurance to cover expanded liability, and may negatively affect fund managers' investment choices if they pursue sub-optimal investment strategies that are designed to ameliorate litigation risk.[91]

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[88] Proposed Rules, p. 15.
[89] MFA Comment Letter, Section IV. C.
[90] MFA Comment Letter, Section IV. B.
[91] MFA Comment Letter, Section IV. C.

54. The Proposed Rules would prevent advisers from negotiating and obtaining provisions in their agreements that would limit their liability.[92] The new standard of care is therefore likely to increase litigation risk and associated costs for fund advisers.[93] For example, if an adviser makes a mistake in executing a client's trade (such as a typo in the order adding an extra "0"), under current regulation, and depending on the terms and disclosures in the applicable fund's governing documents, the adviser could be indemnified for the loss. Under the Proposed Rules, the adviser's liability for such a mistake could not be limited. Additionally, "ordinary" investments that fail to achieve *ex ant*e expectations will be subject to litigation under the proposed standard. For example, a fund manager who bought Russian debt in early 2022 could be subject to litigation from an investor who, with the benefit of hindsight, might claim that it was "negligent" not to take account of the possibility of a Russia-Ukraine conflict. As discussed below, advisers for mutual funds are not held to this same standard. Additionally, this change in the standard of care may incentivize advisers to limit their client base to those parties who they believe present a low risk of litigation. This may specifically harm pension funds or other investors if they are considered litigious.[94] If so, these investors may not be able to access the private fund market as a result of this Proposal. This would make it harder for pension funds and other investors to diversify away from public markets.

55. It is puzzling that the new standard of care is a much stricter liability standard than those that apply to other SEC regulations. These standards include: (1) highly unreasonable conduct, (2) gross negligence, (3) reckless conduct, and (4) knowing or intentional conduct. The Commission fails to articulate why the Proposal mandates the most restrictive standard for a market that is populated by sophisticated investors who, at least in principle, should not need this level of protection.

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[92] Proposed Rules, p. 133. ("Proposed rule 211(h)(2)-1 would prohibit an investment adviser to a private fund, directly or indirectly, from engaging in certain activities with respect to the private fund or any investor in that private fund, including: […] Seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.")

[93] MFA Comment Letter, Section IV. C.

[94] *See* discussion of ERISA investors in MFA Comment Letter, Section IV. C.

5. The Proposed Rules Overlook Other Costs

56. Numerous costs are also likely to arise from other aspects of the Proposal. For example, the Commission fails to demonstrate why a pass-through expense model is not in the best interest of investors, relative to other types of fee arrangements.[95] Some investors may prefer to compensate advisers through a pass-through model because it ensures they are directly compensating the adviser for the adviser's expenses.[96] Thus, a pass-through expense model may increase transparency for the investor.[97] Additionally, although the Commission claims that pass-through expenses are contrary to public interest, compensation from clients, whether in the form of a management fee or a pass-through fee, is required for the adviser to operate a business.[98] The prohibition on pass-through fees is also likely to disproportionately affect smaller and newly-formed investment advisers that have less ability to charge high management fees.[99] Moreover, the Commission cites to a *Seeking Alpha* article discussing high pass-through fees, but does not consider the article's conclusion that "*investors are willing to pay for an edge*."[100]

57. The Commission has not shown why it would be beneficial to impose restrictions on the amount or form in which advisers and fund investors agree to structure their economic relationship. For example, a seed investor in a fund would typically expect preferential treatment based on the additional risk they are taking by investing in an unproven start-up. Such compensation may come in the form of a share of the fees paid to the fund.[101] Overall, the investors agreeing to such terms are sophisticated investors, and logic dictates that if they did not

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[95] Proposed Rules, p. 141. ("We believe allocating these types of expenses to a private fund client is contrary to the public interest and is harmful to investors because they create an incentive for an adviser to place its own interests ahead of the private fund's interests and unfairly allocate expenses to the fund, even where fully disclosed. For example, in some circumstances, an adviser may charge a fund significant fees and expenses in connection with an investigation that may not be in the fund's best interest. Further, as discussed above, we believe the prohibited fees and expenses are related to forming and operating an advisory business and thus should be borne by the adviser and its owners rather than the private fund and its investors."); *See also* MFA Comment Letter, Section V. C.

[96] MFA Comment Letter, Section V. C.

[97] MFA Comment Letter, Section V. C.

[98] MFA Comment Letter, Section V. C.

[99] MFA Comment Letter, Section V. C.

[100] Proposed Rules, p. 192 citing to Eli Hoffmann, "Welcome To Hedge Funds' Stunning Pass-Through Fees," Seeking Alpha (Jan. 24, 2017), available at https://seekingalpha.com/article/4038915-welcome-to-hedge-funds-stunning-pass-through fees.

[101] Christian-Oliver Ewald and Hai Zhang, "Hedge fund seeding via fees-for-seed swaps under idiosyncratic risk," *Journal of Economic Dynamics & Control* 71, 2016, pp. 45–59 at 46. ("This is an arrangement to which we refer as fees-for-seed swap that specifies that a seed investor (or seeder) commonly commits to providing a remarkable amount of seed capital to an ESFs manager as an "anchor investor" in a new fund in exchange for a share of "enhanced economics" which is usually the fees that the ESFs manager generates from the entire pool of assets in the fund. If structured properly, the seeding approach can be highly beneficial to the ESFs manager and to investors who provide the seed capital. It is not uncommon that the hedge fund seeder receives a portion of the hedge fund's revenue stream to get greater return potential than an ordinary investor").

want to invest in funds that charge pass-through fees, they would simply invest with other funds that offer alternative arrangements.[102] The Proposed Rules do not adequately demonstrate the need for regulatory intervention for this private arrangement.

58. In addition, there is substantial evidence demonstrating that both the level and quality of investment returns generated by advisers who use a pass-through model are superior to those generated by advisers without a pass-through expense model. Analysis conducted by the Barclays Prime Services Capital Solutions team found that "multi-managers that include a partial or full pass through have outpaced both multi-managers that do not charge a pass through as well as those with traditional HF fees across net returns, alpha, and Sharpe."[103] Specifically, from 2019 through 2021, multi-manager hedge funds with a full pass-through expense model generated annualized net returns of 12.7% with a Sharpe ratio of 2.2, while multi-manager hedge funds with a non-pass through expense model generated annualized net returns of 7.0% with a 1.2 Sharpe ratio and the range of annualized net returns generated by traditional hedge funds ranged from 8.6% to 9.7% with Sharpe ratios ranging from 0.6 to 0.9.[104] Further, data from the Aurum Hedge Fund Data Engine shows that the cumulative performance on an AUM-weighted basis from January 2012 through March 2022 of hedge funds that charge a pass through was 190.6% compared to 68.8% for hedge funds that charge fixed fees.[105] Over that period, the annualized Sharpe ratio of pass through hedge funds was 2.6, compared to an annualized Sharpe ratio for all hedge funds of 0.9.[106]

59. The proposed changes may ultimately harm investors, if as expected, advisers charge higher management fees to cover anticipated rather than actual expenses. The Commission admits that there are certain costs that may be passed through to investors but does not attempt to quantify the magnitude of these costs and ignores the impact they may have on individual investors. For example, the Commission states: "Advisers could alternatively attempt to introduce substitute charges (for example, increased management fees) in order to cover the costs of compliance with the rule, but their ability to do so may depend on the willingness of investors

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[102] MFA Comment Letter, Section V. C.
[103] Barclays Prime Services Capital Solutions, "Fee Structures by HF Business Model," March 2022, pp. 1–4 at 2.
[104] Barclays Prime Services Capital Solutions, "Fee Structures by HF Business Model," March 2022, pp. 1–4 at 2.
[105] Aurum, "Aurum Hedge Fund Data Engine," available at https://www.aurum.com/aurum-strategy-engine/.
[106] Aurum, "Aurum Hedge Fund Data Engine," available at https://www.aurum.com/aurum-strategy-engine/.

to incur those substitute charges."[107] While the latter half of this statement may be hypothetically possible, the SEC has provided no evidence to justify this would be the case. It is just as likely that the Proposed Rules may cause an industry-wide shift in advisers charging higher management fees.

60. Additionally, I note that the 45-day quarterly statement limit discussed in the Proposal does not align with standard practice in other industries. For example, mutual funds are not subject to this time-frame for reporting quarterly results.[108] In the "Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies," the Commission states:[109]

> *"We are adopting the requirement that a fund file its complete portfolio holdings schedule with the Commission on a quarterly basis, with one modification. A fund will be required to file its complete portfolio schedules for the second and fourth fiscal quarters on Form N-CSR, and will be required to file its complete portfolio schedules for the first and third fiscal quarters on new Form N-Q, within 60 days of the end of the quarter. Form N-Q will require funds to file the same schedules of investments that are currently required in annual and semi-annual reports to shareholders. These schedules may be unaudited."*

61. It is unclear why the mutual fund reporting requirement is less strict than that in the Proposal, where the Commission requires a quarterly statement to be furnished to private fund investors within 45 days after each calendar quarter end.[110]

62. There are other disadvantages that investors may bear as a result of the Proposal. For example, the SEC notes: "The costs associated with obtaining fairness opinions could dissuade some private fund advisers from leading these transactions, which could decrease liquidity opportunities for some private fund advisers. Under current practice, some investors bear the expense associated with obtaining a fairness opinion if there is one. To the extent not prohibited, we expect similar arrangements may be made going forward to comply with the proposed

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[107] Proposed Rules, p. 232.

[108] "Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies," Securities and Exchange Commission, 17 CFR Parts 210, 239, 249, 270, 274, Release Nos. 33-8393; 34-49333; File No. S7-51-02, May 10, 2004, available at https://www.sec.gov/rules/final/33-8393.htm.

[109] "Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies," Securities and Exchange Commission, 17 CFR Parts 210, 239, 249, 270, 274, Release Nos. 33-8393; 34-49333; File No. S7-51-02, May 10, 2004, Section II. B. 4, available at https://www.sec.gov/rules/final/33-8393 htm.

[110] Proposed Rules, p. 287.

rule."[111] If the current practice already enables investors to obtain a fairness opinion if they should want one, it is unclear why the SEC would consider requiring all investors to bear the cost of obtaining a fairness opinion—even if the investor does not demand it. Moreover, certain investors may also have to bear indirect costs, even though the SEC has not shown that the benefit of these changes outweighs the costs. The SEC acknowledges this potential adverse effect:[112]

> *"In addition, investors may incur costs from this prohibition that take the form of lower returns from some fund investments, depending on the extent to which the prohibition limits the adviser's efficiency or effectiveness in providing the services that generate returns from those investments. For example, in the case of pass-through expense models, fund advisers who would have to bear new costs of providing certain services under the prohibition may reduce or eliminate those services from the fund in order to reduce costs, which may be to the detriment of the fund's performance or lead to an increase of compliance risk."*

D. The Commission Neglects to Consider Reasonable and Less Burdensome Alternatives to the Private Funds Proposal

63. I note that there are a number of less costly, but still effective, alternatives the Commission has not considered. For one, the Commission could strengthen transparency and disclosure requirements for advisers around fees and expenses without a complete prohibition on preferential treatment without disclosure.[113] Alternatively, the Commission could require advisers to allocate costs on a "fair and equitable basis" that would be disclosed to investors so that they may provide informed consent.[114]

64. As noted previously, many funds already provide annual audited statements to investors. The Commission could amend the Proposed Rules to state that quarterly statements should also be prepared in accordance with GAAP, so that investors receive consistent information from public and private entities.[115]

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[111] Proposed Rules, p. 259.
[112] Proposed Rules, pp. 236–237.
[113] MFA Comment Letter, Section V. B.
[114] MFA Comment Letter, Section VI. C.
[115] MFA Comment Letter, Section XI.

65. The Commission also proposes that advisers obtain a fairness opinion for every adviser-led investment. Less-costly alternatives to this proposal would include requiring that advisers gain independent agent consent, conduct an auction, or seek a third-party valuation.[116]

IV. Conclusion

66. In sum, I find that the Commission has not adequately demonstrated a justification for the Proposed Rules nor that investors would benefit. The Commission has also omitted discussion of entire categories of potential new costs that could arise from the proposed changes. Rather than lowering fees, the Proposal is likely to disproportionately reduce the ability of smaller and diverse funds to compete and, in turn, harm investors. Lastly, I find that the SEC's Proposal neglects to consider reasonable alternatives that could achieve similar goals but would be less burdensome to implement.

[116] MFA Comment Letter, Section XV.