April 25, 2022

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

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (SEC Release No. IA-5955; File No. S7-03-22 (February 9, 2022)).

Dear Ms. Countryman:

The American Investment Council ("**AIC**") appreciates the opportunity to submit the enclosed comments on the Securities and Exchange Commission's (the "**Commission**") proposed rules (the "**Proposal**") regarding investment advisers to private funds.[1]

The AIC is an advocacy, communications, and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, the AIC develops, analyzes, and distributes information about the private equity and private credit industries and their contributions to the U.S. and global economy. Established in 2007, and formerly known as the Private Equity Growth Capital Council, the AIC is based in Washington, D.C. The AIC's members are the world's leading private equity and private credit firms, united by their commitment to growing and strengthening the businesses in which they invest.[2]

The private equity and private credit industries play a positive role in communities across America. During the pandemic, private equity and private credit investment supported millions of jobs, thousands of small businesses, and delivered the strongest returns for public pensions. This success and growth have in turn delivered billions of dollars in returns for investors and helped launch countless valuable U.S. companies and products. More broadly, private equity

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,886 (Mar. 24, 2022). All citations to the Proposal will refer to the Federal Register page unless otherwise indicated.

[2] For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

and private credit advisers continue to deliver superior returns to investors compared to other asset classes.[3]

The AIC supports an appropriate regulatory framework for private equity and private credit funds and their advisers, and appreciates the opportunity to provide the comments submitted with this letter. The AIC believes that this particular Proposal is unnecessary, and would curb the entrepreneurialism, flexibility, and investment returns that make private funds an increasingly attractive option for the world's most sophisticated investors. The AIC is also concerned that the Proposal exceeds the Commission's statutory authority to regulate in this area.

We hope that the enclosed submission is helpful to the Commission as it considers this important Proposal. We also intend to separately submit responses to certain questions that the Commission posed throughout the Proposal. Due to the volume and complexity of the questions presented, and the unusually short 30-day comment window, our members need additional time to evaluate and provide meaningful responses to the over 900 questions included in the Proposal.

Respectfully submitted,

Drew Maloney
President and CEO
American Investment Council

[3] For purposes of this letter and the attached comments, we generally use the terms "private funds" and "private equity funds" to encompass private equity funds, private credit funds, and other permanent capital vehicles. We refer to their investment advisers as private fund advisers, private equity fund advisers, and fund sponsors.

COMMENTS OF THE

AMERICAN INVESTMENT COUNCIL

(SEC Release No. IA-5955; File No. S7-03-22)

April 25, 2022

TABLE OF CONTENTS

INTRODUCTION AND EXECUTIVE SUMMARY

Private equity is a significant contributor to the U.S. economy.[4] As of 2020, the sector included approximately 4,500 private equity firms and 16,000 companies backed by private equity capital, employing approximately 11.6 million people.[5] Private equity firms invest in mature and growth-stage businesses to provide needed capital, to provide expertise that bolsters performance, or both. For these businesses, private equity is a key source of capital that may be unavailable or too costly to obtain from other sources, such as public market capital.

Private equity is a proven investment strategy that has consistently outperformed public markets over the last 20 years.[6] Private equity improves productivity by increasing capital expenditures and channeling resources to more productive uses,[7] delivering improvements in both sales and operating margins.[8] For investors, investing in private equity has been shown to increase average portfolio returns and portfolio "Sharpe ratios"—a measurement of risk-adjusted return.[9] From 2005 to mid-2021, private equity distributed more than $2.7 trillion to investors.[10]

By Congressional design, investment in private equity is reserved primarily for investors with significant investment holdings— who are well-positioned to appraise a private equity investment, have the experience and leverage to negotiate appropriate investment terms, and are

---

[4] Except as noted, the industry statistics are from EY, *Economic contribution of the US private equity sector in 2020, Prepared for the American Investment Council* (May 2021), https://www.investmentcouncil.org/wp-content/uploads/ey-aic-pe-economic-contribution-report-final-05-13-2021.pdf.

[5] Estimates exclude indirect effects of suppliers to the private equity sector and related consumer spending.

[6] *See* Stephen L. Nesbitt, Cliffwater, *Long-Term Rewards from Private Equity* (Mar. 2021). For example, over the last 20 years, pension funds have earned returns of 9.25% per year in private equity, as opposed to only 5.4% per year in the public markets. *Id.* Other data show similarly strong results for private equity investments. The *median* return of institutions with a portfolio of at least 30% private equity is higher than the *top return* of institutions with portfolios of less than 10% private equity. Maureen Austin & David Thurston, Cambridge Associates, *Building Winning Portfolios Through Private Investment* (Aug. 11, 2021); *see also* Final Rule, Accredited Investor Definition, 85 Fed. Reg. 64,234, 64,267 (Oct. 9, 2020) ("All else equal, expanding the set of investment opportunities can increase diversification and improve the risk-return tradeoff of an investor's portfolio. More specifically, adding private investments to the set of investable assets could allow an investor to expand the efficient risk-return frontier and construct an optimal portfolio with risk-return properties that are better than, or similar to, the risk-return properties of a portfolio that is constrained from investing in certain asset classes, leading to a more efficient portfolio allocation. For example, recent research has shown that investments in funds of private equity funds can outperform public markets. Thus, to the extent access to private offerings expands the efficient risk-return frontier for newly eligible accredited investors and qualified institutional buyers, we expect these investors will potentially benefit from an improvement in portfolio efficiency.") (footnotes omitted).

[7] Quentin Boucly, David Sraer & David Thesmar. *Growth lbos, Journal of Financial Economics* 102.2 (2011): 432-453; Steven J. Davis, et al., *Private equity, jobs, and productivity, American Economic Review* 104.12 (2014): 3956-90.

[8] Viral V. Acharya, et al., *Corporate governance and value creation: Evidence from private equity, The Review of Financial Studies* 26.2 (2013): 368-402; Shourun Guo, Edith S. Hotchkiss & Weihong Song, *Do buyouts (still) create value?, The Journal of Finance* 66.2 (2011): 479-517.

[9] Gregory Brown, Wendy Hu & Bert-Klemens Kuhn, *Private Investment in Diversified Portfolios* (Jan. 2021).

[10] Based on data from PitchBook.

best able to absorb investment losses should they occur.[11] These investors include the world's largest pension funds and professionally-managed university endowments and charitable foundations. In negotiating investment terms, they often are represented by some of the world's leading law firms.[12]

Private fund investors have substantially increased their holdings in private equity in recent years. Among sampled pension funds, for example, the median allocation to private equity has risen from less than 1 percent in 2001 to approximately 9 percent in 2020.[13] These investors are seeking out private equity (and intend to continue to do so)[14] precisely because it is a successful, healthy, and thriving sector of the economy, providing returns that exceed those available in publicly-traded securities and a range of other available investment options.[15] Investors with this degree of sophistication—many of whom, such as pension plans, owe fiduciary duties to their beneficiaries—would not (and could not) be shifting their capital to private equity if they lacked sufficient information to make responsible, remunerative investment decisions, or if they were unable to achieve satisfactory contractual terms through negotiation with fund advisers.[16]

Indeed, private equity in recent years has been characterized not only by favorable returns and increased holdings by some of the world's leading investors, but also by abundant evidence of those investors' ability to use their expertise and negotiating leverage (and top-notch, expert legal counsel) to achieve favorable changes in common contractual terms.[17] Private equity firms are close partners with their investors, work well with them, and value these relationships.

---

[11] *See* 15 U.S.C. §§ 80a-3(c)(7)(A), 80a-2(a)(51).

[12] Prominent investors in private equity include numerous sovereign wealth funds; CalPERS and CalSTRS, two of the world's largest pension funds; the Yale and Harvard endowments, the two largest university endowments in the United States; and large foundations such as the Ford Foundation and the Rockefeller Foundation. Law firms specializing in representing private equity investors when negotiating investment terms include DLA Piper, a firm of 4,300 lawyers; Goodwin Procter LLP, a firm of more than 1,400 lawyers; K&L Gates LLP, a firm of approximately 1,500 lawyers and Morgan Lewis.& Bockius LLP, a firm of approximately 2,000 lawyers.

[13] Center for Retirement Research at Boston College, MissionSquare Research Institute, National Association of State Retirement Administrators, and Government Finance Officers Association, *Public Plans Data 2001-2020*.

[14] According to Private Equity International's December 2021 survey, 93% of institutional investors expect to allocate the same amount or more to private equity in the coming year. This positive experience with private equity belies the premise of the Proposal.

[15] *See* Heather Gillers, *Retirement Funds Bet Bigger on Private Equity*, Wall St. J. (Jan. 10, 2022), https://www.wsj.com/articles/retirement-funds-bet-bigger-on-private-equity-11641810604.

[16] *See* Report of Professor S.P. Kothari ¶¶ 22-23 (Apr. 25, 2022) ("Kothari Report").

[17] Management fee rates are now generally under the 2% rate cited by the Commission (at, *e.g.*, Proposal at 16,893). *See, e.g.*, Key Findings ILPA Industry Intelligence Report: What Is Market In Fund Terms? (2021), https://ilpa.org/wp-content/uploads/2021/10/Key-Findings-Industry-Intelligence-Report-Fund-Terms.pdf (reporting management fee rates of 1.5% to 2.0%); *see also* Proposal at 16,940 n.263 (estimating private equity fund management fees to be 1.76%). Large investors, including those representing a significant number of pensioners, have negotiated even lower fees. And while, in 2006, funds would offset only around 70% of transaction fees, *see* Preqin, 2006 Fund Terms Advisor, the standard is now a 100% offset for transaction, monitoring, or financing fees, *see* Preqin, 2021 Private Capital Fund Terms Advisor; MJ Hudson 2021 Private

All these developments reflect healthy, robust private-ordering by which well-matched counterparties are able to develop and evolve contractual terms that further the unique benefits of private equity investing while satisfying the objectives of both advisers and investors. Moreover, fund managers often take different approaches in these negotiations, allowing private fund investors to weigh the benefits and costs of different terms and decide which terms are best tailored to their needs. And because the private equity industry is unconcentrated, investors have substantial flexibility to switch firms if they are dissatisfied with the terms being offered by a particular firm. The variation in fund terms promotes competition and is evidence of a functioning—not broken—market. Even a report from Institutional Limited Partners Association ("**ILPA**") that the Commission cites as support for the broader need for the proposal acknowledges that "[c]lear and consistent reporting of fees and expenses is an area that has seen real progress."[18]

Despite all this, and for reasons not fully explained, the Commission is now proposing to thrust upon this thriving, competitive (and even crowded)[19] sector the most costly, intrusive set of requirements ever imposed on private funds and their advisers. The Commission suggests the Proposal will help avert fraud in private funds, but it nowhere demonstrates that the existing regulatory regime—and the resources and rights of action available to private equity's experienced investors—are insufficient to detect and redress fraud when it occurs.[20] Indeed,

---

Equity Fund Terms Research. *See also* ILPA 2021 Industry Intelligence Report – Key Findings (identifying other favorable changes in contractual terms for investors); 2020 Private Funds CFO Fees & Expenses Survey (same).

In addition, a large number of firms have substantially adopted the template from the Institutional Limited Partners Association ("ILPA") for reporting. ILPA is an association of private equity investors that includes the world's largest pension funds; MetLife, Wells Fargo, and other large insurers and banks; and the World Bank and the sovereign wealth funds of several Middle Eastern nations. Approximately 60% of its membership is U.S.-based, with the remaining members based throughout the rest of the world. *See* Institutional Limited Partners Ass'n, *Who We Are*, https://ilpa.org/about/; Institutional Limited Partners Ass'n, *Member List*, https://ilpa.org/member-list/.

Senior officials of the Commission have noted these improvements. *See* Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement, Andrew Ceresney (May 12, 2016), https://www.sec.gov/news/speech/private-equity-enforcement.html ("Our sense is that through the Commission's focus on the industry, we have helped to significantly increase the level of transparency into fees, expenses, and conflicts of interest, and have prompted real change for the benefit of investors …. In short, I think our private equity actions have led to significant change in the private equity industry, all to the benefit of investors.").

[18] Proposal at 16,894; Key Findings ILPA Industry Intelligence Report: What Is Market In Fund Terms? (2021), https://ilpa.org/wp-content/uploads/2021/10/Key-Findings-Industry-Intelligence-Report-Fund-Terms.pdf ("Clear and consistent reporting of fees and expenses is an area that has seen real progress.").

[19] *See Rise in Private Equity Allocations Looks Unstoppable, For Now*, Private Equity Wire (Mar. 15, 2022), https://www.privateequitywire.co.uk/2022/03/15/312892/rise-private-equity-allocations-looks-unstoppable-now (concluding that 2022 is set to be the most competitive fundraising market yet); Kothari Report ¶ 24 (noting that the private fund sector has "5,037 registered private advisers with $18 trillion assets under management," along with a significant "number of new entrants, with between 15% and 33% of fundraising [being] conducted by first-time funds").

[20] Indeed, the Commission nowhere demonstrates that fraud is any more present in this sector than in any other the Commission regulates.

many of the concerns raised by the Commission have been addressed in the wake of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, when private fund advisers first became subject to the Advisers Act.[21] And these concerns arise very infrequently. The Commission cites just 20 enforcement actions, many from a number of years ago, spanning a 16-year period (for an average of 1.25 actions per year), which is far from an adequate basis to justify such a drastic change in the regulatory regime. Moreover, by the Commission's own account, these enforcement actions involved misconduct governed by, and detected through, the existing regulatory regime—and the Commission fails to establish a greater presence than in other sectors, which are populated with investors that have much less financial wherewithal than investors in private equity. In the end, the Commission appears to be targeting certain investment terms that it arbitrarily considers unfair, but it fails to establish that investors have been harmed by those terms. Indeed, the Commission fails to show that eliminating those terms will offer any real benefit, much less a benefit that exceeds the Proposal's substantial costs. Instead, the Commission's overall agenda appears to be a flawed effort to "mutual fund-ize" and commoditize the private equity sector, in direct contravention of Congressional intent.

The Proposal also imposes a number of onerous disclosure and other requirements, which the Commission attempts to justify by asserting that the investors in private funds do not have "sufficiently detailed information" about their investments and are therefore at a disadvantage when negotiating with advisers.[22] But the Commission fails to substantiate its suggestion that private fund investors lack bargaining power, much less its assumption that investors will benefit from the types of details required here. The Commission also fails to account for several less burdensome alternatives to the Proposal as a whole and to individual portions of the Proposal.

Because this rule is not necessary—and will therefore impose costs and constraints that are not justified—the Commission should, for that reason alone, withdraw the Proposal and not proceed to a final rule. And the Proposal is fundamentally flawed and should not be adopted for numerous other reasons as well:

I. The Proposal exceeds the Commission's statutory authority and is inconsistent with the Commission's obligations and authority under the Advisers Act and the Administrative Procedure Act. As shown below in pages 7-30 of this comment, private funds and their investors are subject to a completely different regulatory architecture than their public, retail investor-facing counterparts. Because, in part, of the greater wealth and sophistication of private fund investors, Congress has purposely and repeatedly applied to private funds a regulatory approach that is different in kind from the thoroughgoing regulatory requirements for registered investment companies ("**RICs**"), and retail investors and their brokers. The Proposal ignores this crucial distinction, introducing invasive requirements that in some instances exceed the requirements that Congress itself imposed on more highly-regulated retail investment relationships and vehicles like RICs. A decision to treat funds for highly sophisticated investors the same as—or more stringently than—funds for retail investors, if adopted, is a slippery slope for regulation that has no clear stopping point. These proposed requirements are outside the

[21] *See* Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010) ("Dodd Frank Act").

[22] Proposal at 16,888.

Commission's authority and unauthorized by the statutory provisions the Commission cites in their support. They are also invalid under the Advisers Act and the Administrative Procedure Act ("**APA**") because the Commission has failed to make the threshold showing needed under the APA for any regulatory action—that the action is *needed*—and because the proposed rules' terms themselves are unwarranted, burdensome, and will harm advisers, funds, and investors in a manner that impairs efficiency, competition, and capital formation. With its short comment period, moreover, the Commission has failed to afford affected parties a meaningful opportunity to participate in the rulemaking, thereby impairing its own ability to obtain the input and information the Proposal admitted it needed to obtain. With more time, market participants could provide the data and analyses needed to gain a full understanding of the economic effects of the Proposal.

II. Numerous specific provisions in the Proposal are unwarranted and will have adverse consequences for private funds and their investors. As discussed in detail at pages 30-64 below, four distinct categories of requirements in the Proposal are unwarranted and will impair rather than enhance the management and performance of private funds.

A. The prohibited practices provisions. The Proposal would improperly prohibit widely-accepted and well disclosed contract terms that benefit advisers, private funds, and their investors. These include the Proposal's prohibition of agreements to indemnify advisers for negligence, a limitation that Congress itself declined to impose on managers of RICs, and that would introduce needless costs and a fear of liability that discourages the entrepreneurialism at the heart of alternative asset management. The Proposal would prohibit various fees and expenses that have long been closely-negotiated between advisers and investors and that, the Commission admits, advisers could simply charge as part of an overall management fee. These prohibitions threaten to decrease investors' returns and to reduce investor choice by driving smaller advisers from the market. The Commission would also place an unnecessary restriction on advisers' ability to deduct tax obligations from the amounts "clawed back" by funds in certain circumstances, another widely-accepted practice that the Proposal simply misunderstands, and that advisers fully disclose and use to help protect their employees from out-of-pocket losses. And, the Proposal would regulate the side letters that advisers enter into with certain investors, at the investors' own request, yet another widely-accepted practice that investors insist upon and often is critical to funds' ability to attract the substantial initial investments needed to launch a fund.

These, and other prohibitions in the Proposal, improperly insert the Commission into arm's-length negotiations between some of the most sophisticated and best-advised counterparties in the world, conferring new contractual rights and terms on investors that they do not need, and that the Commission lacks the authority to bestow.

B. The adviser-led secondaries rule. The Proposal would impose a number of burdensome requirements on adviser-led secondary transactions, which would have the effect of reducing the returns of private fund investors. An adviser-led secondary transaction offers fund investors an alternative access to liquidity—either by selling all or a portion of the investor's interest in the fund, or by converting all or a portion of the

investor's interest into another fund advised by the same adviser. The Proposal would require fund advisers, prior to the closing of any adviser-led secondary transaction, to obtain an independent fairness opinion on the offering price and to disclose any material business relationships between the adviser and the opinion provider. This requirement is often unnecessary, as other means of verifying price information are often more reliable and less costly to investors. Advisers should be encouraged to pursue the most reliable method of determining purchase price and to avoid unnecessary delay, which can put transaction completion at risk, and to avoid incurring unnecessary costs ultimately borne by investors.

C. The disclosure requirements. The Proposal would impose several burdensome disclosure requirements on advisers, increasing costs without offsetting benefits. These include a one-size-fits-all requirement that advisers issue quarterly statements with highly detailed information about fees, expenses, and fund performance within a mere 45 days after the quarter's end. This requirement would mire advisers in collecting and reporting vast amounts of information in a short period, increasing costs, reducing returns, and posing a particular threat to smaller advisers and new market entrants that lack the necessary back-office infrastructure. It will raise even more significant challenges for funds-of-funds and secondary funds. The Commission's indiscriminate approach fails to adequately tailor the reporting requirements to the capabilities and needs of specific funds. The reporting requirements are also unnecessary because investors in private funds that need specialized reporting already receive—and negotiate for—customized disclosures of relevant information tailored to their needs. Similarly, many advisers already have templates for quarterly statements and other reports. The Commission does not need to mandate yet another way of presenting the same or similar information.

D. The audit requirements. The Proposal would require all private funds to obtain audits in accordance with a variety of specifications. But these audit requirements are duplicative and unnecessary, overlapping in many respects with existing mandates without delivering any notable benefit.

The cumulative effect of these unnecessary changes will be to stifle a particularly vibrant sector of the financial services industry—saddling it with unjustified burdens and constraints. Entrepreneurialism will be curbed, together with the contributions that private-equity-backed companies make to the U.S. economy. The blow will fall particularly hard on new market entrants and smaller fund sponsors, which are more likely to be women- or minority-owned than

larger private equity firms[23] but often lack the resources to implement these requirements. Efficiency, competition, and capital formation will all be impaired.[24]

* * *

Just three years ago, the Commission released its 2019 Advisers Act "**Fiduciary Interpretation**,"[25] which expressly acknowledged and preserved the benefits of the current system for achieving contract terms through arm's-length negotiation between private fund advisers and investors. The Commission has provided no justification for its sudden, sharp reversal toward this thriving sector of the economy. The proper course for the Commission now is not to proceed with this Proposal, but instead to allow advisers and investors to continue to absorb the Interpretation and respond appropriately, and for the Commission and its staff to take the time needed to appraise whether the Interpretation is achieving its intended effects.

I. THE PROPOSAL AS A WHOLE IS UNLAWFUL.

The Commission's Proposal to require private fund advisers to abandon longstanding, legitimate business practices, and to provide costly quarterly disclosures, is unlawful: the Proposal exceeds the Commission's statutory authority; is arbitrary and capricious under the Administrative Procedure Act;[26] and is unduly costly and not consistent with the Commission's statutory duty to consider whether its action will promote efficiency, competition, and capital formation.[27]

A. The Commission Lacks Statutory Authority To Adopt The Proposal.

The Proposal falters at the starting gate because it exceeds the Commission's statutory authority. Like other federal agencies, the Commission "literally has no power to act . . . unless

---

[23] Minority and women-owned businesses represent a fraction of the asset management industry, and therefore can be expected to constitute a greater percentage of new entrants to the market. *See, e.g.*, Securities and Exchange Commission Asset Management Advisory Committee - Subcommittee on Diversity and Inclusion - Recommendations for Consideration by the AMAC on July 7, 2021, https://www.sec.gov/files/amac-recommendations-di-subcommittee-070721.pdf.

[24] The Proposal will, among many other things, dramatically affect the collateralized loan obligation ("**CLO**") market since many CLOs rely on exemptions under sections 3(c)(1) or 3(c)(7) of the Investment Company Act, and thus would expressly meet the definition of "private fund" for purposes of the Proposal. We view the application of the Proposal to CLOs as additional evidence of the hurried and unrefined nature of the Proposal and the Commission's failure to tailor the Proposal to apply more specifically to different structures and products to the extent actual harms exist. We are aware that other interested parties will submit comment letters on the Proposal on behalf of CLO sponsors, and such letters will express the view that the Proposal should not apply to CLOs due to the structural and commercial aspects of CLOs that differentiate them from private funds.

[25] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669 (July 12, 2019).

[26] *See* 5 U.S.C. § 706(2)(A).

[27] *See* 15 U.S.C. § 80b-2(c).

and until Congress confers power upon it."[28] Here, the Commission points to sections 206 and 211(h) of the Advisers Act[29] as the sources of authority for the Proposal.[30] But neither of those provisions authorizes the Commission to adopt the prohibitions on longstanding business arrangements and requirements for detailed reporting contemplated by the Proposal.

1. The Proposal, As A Whole, Is Inconsistent With The Statutory Structure And Congress's Unique Treatment Of Private Funds.

For reasons set forth in the sections that follow, the Proposal is not authorized by the provisions of the Advisers Act on which the Commission purports to rely. Perhaps even more importantly, the Proposal misapprehends and conflicts with the entire framework Congress established for the regulation of private funds.

In the Investment Company Act of 1940 (the "**Investment Company Act**"), Congress set forth a detailed regulatory structure for RICs, governing almost every aspect of investment companies' operations. Federal law, for example, governs an investment company's board of directors,[31] functions and activities,[32] size,[33] contractual relationships with advisers and underwriters,[34] transactions with affiliated persons,[35] capital structure,[36] payments or distributions,[37] proxies,[38] lending relationships,[39] and distributions, redemptions, and repurchases of securities,[40] among other things.

Congress purposefully exempted private funds from this extensive regulatory regime. Because the "qualified purchasers"[41] invested in private funds are large, extremely sophisticated

---

[28] *N.Y. Stock Exch. LLC v. SEC*, 962 F.3d 541, 553 (D.C. Cir. 2020) (ellipsis in original) (quoting *La. Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374 (1986)).

[29] 15 U.S.C. §§ 80b-6, 80b-11(h).

[30] *See* Proposal at 16,974. The Commission also cites sections 203(d) and 211(a), *see id.*, but neither confers independent rulemaking authority here beyond whatever authority sections 206(4) and 211(h) confer. Section 203(d) merely provides that certain prohibitions under the Advisers Act apply to registered investment advisers and their agents, 15 U.S.C. § 80b-3(d), and section 211(a) is a general rulemaking provision that refers to "powers conferred upon the Commission elsewhere in this subchapter," *id.* § 80b-11(a).

[31] *See* 15 U.S.C. §§ 80a-10, 80a-16.

[32] *See id.* § 80a-12.

[33] *See id.* § 80a-14.

[34] *See id.* § 80a-15.

[35] *See id.* § 80a-17.

[36] *See id.* § 80a-18.

[37] *See id.* § 80a-19.

[38] *See id.* § 80a-20.

[39] *See id.* § 80a-21.

[40] *See id.* § 80a-22.

[41] *Id.* § 80a-3(c)(7)(A); *see also id.* § 80a-2(a)(51).

investors,[42] Congress presumed they were well-positioned to appreciate and bear the risks associated with their investments, and to "evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights."[43] Private funds, in other words, are set apart from other segments of the investor community—and Congress recognized that.[44] The Dodd-Frank Act framework did not disturb this balance.

Instead of allowing private fund investors to work out the terms of their own investments as Congress intended and as they have for decades without systematic dysfunction or unfairness, the Commission proposes a litany of extremely costly, unnecessary disclosures, along with a paternalistic prohibition on longstanding business practices, viewing terms of lengthy and complex agreements in isolation rather than as parts of a fully integrated and heavily negotiated whole. The Proposal not only subjects private funds to some of the same types of regulation as RICs, it actually imposes *more stringent* restrictions on private funds. In the Investment Company Act, for example, Congress provided that retail investment funds—with retail investors—could not indemnify their investment adviser for "gross negligence."[45] Yet here, the Commission would bar private funds—with large, highly sophisticated investors—from indemnifying their investment advisers for even simple negligence. That does not make any sense and highlights the overarching flaw of the Commission's Proposal: where Congress has determined that certain funds, given the size and sophistication of their investors, should be free from costly, unnecessary regulation, the Commission is not at liberty to nevertheless impose that regulation (or even more stringent regulation).

2. The Quarterly-Reporting Rules Exceed The Commission's Authority.

The Advisers Act contains a number of provisions that govern an investment adviser's reporting and disclosure obligations, but the Commission does not rely on those provisions in support of the proposed quarterly-reporting rules—and for good reason: none of them applies. Section 203(c) requires investment advisers applying to register with the Commission to report specific information about their business, such as the education of the adviser.[46] Section 204(b) authorizes the Commission to require registered investment advisers to provide a "description" of certain information, such as the type of assets held by each fund the adviser advises.[47] Neither of those provisions authorizes the Commission to require—as the Commission proposes here—

---

[42] These investors hold at least $25 million (and often much more) in investments. *Id.* § 80a-2(a)(51)(A)(iv).

[43] *Prohibition of Fraud By Advisers of Certain Pooled Investment Vehicles*, Securities Act Release No. 8766, 2006 WL 3814994, at *8 n.45 (Dec. 27, 2006); *see also* Kothari Report ¶ 23 ("economic literature suggests that sophisticated investors are well equipped to protect their interests"); Report of Mark J. Flannery, Ph.D ¶ 45 (Apr. 25, 2022) ("Flannery Report").

[44] In further recognition of the size and sophistication of private fund investors, Congress exempted from registration under the Advisers Act advisers to private funds that have less than $150,000,000 in assets under management. *See* 15 U.S.C. § 80b-3(m)(1).

[45] *See id.* § 80a-17(i).

[46] *See id.* § 80b-3(c)(1).

[47] *See id.* § 80b-4(b)(3).

private fund advisers to issue detailed quarterly reports disclosing the past performance of funds and the fees and expenses that were ultimately paid by the funds.[48]

Although the Commission's proposed codification for the quarterly-reporting rules is 17 C.F.R. § 275.211(h)(1)-2,[49] the Commission nowhere attempts to explain how section 211(h)(1) of the Advisers Act authorizes these rules. Section 211(h)(1) does not. That provision authorizes the Commission to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with . . . [their] investment advisers."[50] But, here, the contemplated disclosures go well beyond the "terms" of the advisory relationship[51] or any of the other information Congress authorized the Commission to require to be disclosed. Details about the past performance of funds and the fees that are ultimately paid to the adviser are not the "terms of th[e] relationship" between investors and advisers. The terms of the relationship, including any conflicts of interest, are necessarily set forth in the contracts, and the disclosures incorporated into those contracts, between the investors and advisers executed at the outset of the advisory relationships; these terms are not and cannot be set forth in disclosures provided after the fact. Disclosures that may "shape the terms of [the] relationship" are not themselves disclosures of "the terms of [that] relationship[ ]."[52] Section 211(h)(1) does not apply.

Perhaps recognizing as much, the Commission appears to attempt to ground the proposed reporting rules in section 206(4)—a general anti-fraud provision.[53] That provision authorizes the Commission to "define, and prescribe means reasonably designed to prevent" "acts, practices, and courses of business" that are "fraudulent, deceptive, or manipulative."[54] But the Commission's proposed reporting rules exceed the authority of section 206(4) in three ways.

First, section 206(4) requires the Commission to specifically "define" an act, practice, or course of business that is "fraudulent, deceptive, or manipulative" before the Commission can prescribe "means reasonably designed to prevent" "such" act, practice, or course of business.[55] Here, the Commission has failed to "define" a fraudulent, deceptive, or manipulative act. The Commission's vague assertion that, without the proposed reporting rules, fund performance may

---

[48] *See* Proposal at 16,976 (proposing to require disclosure of multiple categories of information, including "all compensation, fees, and other amounts allocated or paid to the investment adviser," "all fees and expenses paid by the private fund," a "table for the private fund's covered portfolio investments," and a wide variety of "performance measures").

[49] Proposal at 16,976.

[50] *See* 15 U.S.C. § 80b-11(h)(1).

[51] *Id.*

[52] *See* Proposal at 16,943 ("[E]nhanced disclosures would help investors shape the terms of their relationship with the adviser of the private fund.").

[53] *See* Proposal at 16,976 (justifying the proposed reporting rules as "a means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative").

[54] 15 U.S.C. § 80b-6(4).

[55] *Id.*

be "manipulated"[56] falls far short of the definitional specificity that Congress has required. Before the Commission can assess whether a proffered "means" is "reasonably designed to prevent" a fraudulent act, the Commission must clearly articulate the metes and bounds of that act. Moreover, the Commission must show in the administrative record that the bad acts actually exist and are not merely speculative or hypothetical. This the Commission has not done.

Second, section 206(4) does not authorize the Commission to require disclosure and reporting. If Congress had wished to give the Commission power to require private fund advisers to issue detailed reports to investors on fund performance and fees paid, it would have granted that power expressly. As discussed, Congress explicitly provided for the disclosure and reporting of a multitude of other data points.[57] These provisions show that where "Congress wanted to provide for" the reporting and disclosure of certain information, "it did so explicitly."[58] Indeed, the Dodd-Frank Act did so in many respects, but not in any of the ways that the Commission seeks to impose here. To permit the Commission to smuggle through the backdoor of an anti-fraud provision a general authority to require broad disclosure and reporting would be to "effectively read" the Adviser Act's specific disclosure provisions "out of the statute."[59]

Third, section 206(4) is a limited grant of authority to the Commission to "prescribe means reasonably designed to prevent" "acts, practices, and courses of business" that are "fraudulent, deceptive, or manipulative." But here, the Commission has failed to show that the proposed reporting rules are "reasonably designed" to prevent such misconduct. The Commission vaguely asserts that the proposed disclosures "may allow an investor to identify when the private fund is incorrectly, or improperly, assess[ing] a fee or expense by the adviser,"[60] but the Commission fails to explain how the Proposal would actually prevent a deliberate fraud, as opposed to a simple mistake. The Commission's real objective appears, in its words, to be providing investors with "information that would help inform [their] investment decisions."[61] The Commission repeatedly insists that the proposed reporting rules would allow investors to "better" "assess and compare" their investment options[62] —a laudable goal, but one that has nothing to do with preventing fraud. The Commission may not expand its statutory authority simply because the Commission believes its "preferred approach would be better policy."[63] Nor may it use the section 206(4) anti-fraud authority to impose onerous disclosure

---

[56] Proposal at 16,941.

[57] *See* 15 U.S.C. §§ 80b-3(c)(1), 80b-4(b)(3), 80b-11(h)(1).

[58] *Barnhart v. Sigmon Coal Co.*, 534 U.S. 438, 452 (2002).

[59] *Lane v. Pena*, 518 U.S. 187, 199 (1996); *see also, e.g.*, *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 646 (2012) ("[G]eneral language of a statutory provision, although broad enough to include it, will not be held to apply to a matter specifically dealt with in another part of the same enactment.").

[60] Proposal at 16,890.

[61] *Id.*

[62] *Id.*

[63] *Va. Dep't of Med. Assistance Servs. v. U.S. Dep't of Health & Human Servs.*, 678 F.3d 918, 926 (D.C. Cir. 2012).

requirements to achieve a range of purported benefits that might, incidentally, include fraud prevention, especially in the complete absence of evidence that those requirements would have any such effect.

The Commission's failure to identify and substantiate specific fraudulent conduct or practices that its reporting rules would prevent is particularly problematic here, where the Proposal generally seeks to protect large, "highly sophisticated investors, termed 'qualified purchasers,'"[64] that already receive extensive quarterly, or otherwise periodic, reporting from advisers. Qualified purchasers are presumed to be "in a position to appreciate the risks associated" with their investments and to "evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights."[65] In practice, the limited partners of private funds not only are in a position to do so, they actually do so: there is regular dialogue and communication between limited partners and general partners on a wide range of issues, including those toward which these new rules are supposedly directed.[66] The Commission must carry an especially heavy burden to show that such investors are in need of added protection. It has not come close to that showing. And even if it had, the Commission has failed to show that the proposed reporting rules are a "reasonably designed means" to achieve the desired anti-fraud goal,[67] given the enormous burden the proposed reporting rules will impose on advisers.[68]

3. The Prohibited-Activities Rules Exceed The Commission's Authority.

The proposed prohibited-activities rules also clearly exceed the Commission's authority. The rules amount to an unprecedented regulatory intrusion into the inner workings of private funds—a rewriting of highly detailed contracts freely negotiated among some of the most financially and legally sophisticated parties in the world. As the Commission itself has long recognized, the "federal securities laws . . . are based on a simple and straightforward concept: everyone should be treated fairly and have access to certain facts about investments and those who sell them."[69] If the facts are fairly disclosed, it is not the role of the Commission to limit access to investments based on the Commission's subjective view of whether the investments are a good idea. Still less has Congress made it the Commission's role to dictate the terms of private

---

[64] *Privately Offered Investment Companies*, Investment Company Act Release No. 22,597, 1997 WL 156653, at *1 (Apr. 3, 1997). The proposed rules apply to private fund advisers. Proposal at 16,887. Private funds are funds that would be investment companies, but for section 3(c)(1) or 3(c)(7) of the Investment Company Act, 15 U.S.C. § 80a-3(c)(1), (c)(7). Proposal at 16,887 n.2. Section 3(c)(7) of the Investment Company Act exempts from the definition of investment company funds that are owned by "qualified purchasers." 15 U.S.C. § 80a-3(c)(7). Most of the investors in private funds are qualified purchasers. *See generally id.* § 80a-2(a)(51) (defining "qualified purchaser").

[65] *Prohibition of Fraud By Advisers of Certain Pooled Investment Vehicles*, Securities Act Release No. 8766, 2006 WL 3814994, at *8 n.45 (Dec. 27, 2006).

[66] *See* Flannery Report ¶¶ 7, 17 (Apr. 25, 2022) ("Flannery Report").

[67] 15 U.S.C. § 80b-6(4).

[68] *Infra* at 52-61.

[69] SEC, *What We Do*, https://www.sec.gov/about/what-we-do (last visited Apr. 25, 2022).

commercial contracts under which parties, each with appreciable bargaining power, decide how such investments should be made. Yet that is exactly what the Commission proposes here: the prohibited-activities rules, if adopted, will prevent investors from continuing to negotiate widely accepted private-fund structures.

The Commission points to section 211(h)(2) of the Advisers Act as the source of authority for these unprecedented rules.[70] But "Congress does not alter a regulatory scheme's fundamental details in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes."[71] And as shown below, section 211(h), which was enacted as part of a clean-up section in the Dodd-Frank Act regarding "Other Matters,"[72] does not remotely authorize the Commission to go from a disclosure regime to one of substantive economic regulation that bars longstanding, widely used fund structures from being freely chosen in arm's-length transactions by some of the world's largest investors.

Section 211(h)(2) authorizes the Commission to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."[73] The proposed prohibited-activities rules exceed this authority in two independent ways: they do not regulate "certain sales practices, conflicts of interest, and compensation schemes," and they are not in the public interest or needed for the protection of investors.

a) The Proposed Prohibited-Activities Rules Do Not Regulate "Certain Sales Practices, Conflicts Of Interest, And Compensation Schemes."

The proposed prohibited-activities rules do not regulate "certain sales practices, conflicts of interest, and compensation schemes" within the meaning of section 211(h). The Commission seeks to read this provision so broadly as to authorize treating private fund investors as ordinary retail customers or as advisers' clients.[74] But statutory context, including express carve-outs in neighboring provisions (sections 211(a) and 211(g)), makes clear that section 211(h) cannot be read in that way.

---

[70] *See* Proposal at 16,920 ("We are also proposing to prohibit a private fund adviser from engaging in certain sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors.").

[71] *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468 (2001).

[72] Dodd Frank Act § 913(g)(2).

[73] 15 U.S.C. § 80b-11(h)(2).

[74] This reading starts down a slippery slope that could empower the Commission to change the terms of contracts. For example, the Commission asks whether it should prohibit the management fee and carry model of fees. *See* Proposal at 16,891 ("Should we prohibit certain compensation arrangements, such as the '2 and 20' model?").

"It is a 'fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme.'"[75] Read in context, the phrase "certain sales practices, conflicts of interest, and compensation schemes" refers to the promotional methods employed by broker-dealers and investment advisers—and the structural incentives they face—in recommending securities transactions to retail investors who seek guidance from these intermediaries to meet their own and their families' financial goals.[76] The proposed prohibited-activities rules exceed this authority because they seek to regulate not the way in which private fund advisers solicit investments in private funds, but the terms of those investments, including what amount to price and commercial terms—such as the payment of certain regulatory or compliance expenses, the formula for calculating the amount of clawback payments, and when funds must bear indemnification payments.

In section 211(h), Congress "group[ed]" three items "in a list"[77] —sales practices, conflicts of interest, and compensation schemes. Under the "traditional canon of construction, noscitur a sociis," these terms "should be given related meaning."[78]

Start with "sales practice." The plain meaning of "sales practice" is a mode or method of making sales. The word "sales" refers to "operations and activities involved in promoting and selling goods or services."[79] And "practice" means "the usual mode or method of doing something."[80] Taken together, those terms refer to promotional methods in making sales of a good or service. In the context of investment advisory services, the quintessential example of a sales practice is a recommendation. This plain meaning of "sales practices" is consistent with its meaning in the securities markets. When Congress enacted Dodd-Frank, it legislated against the background of a broad recognition that sales practices involved certain affirmative, promotional methods, such as aggressive cold-calling campaigns, employed by brokers, dealers, and investment advisers to induce investors to enter into certain securities transactions.[81]

---

[75] *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000).

[76] *See* SEC, Study on Investment Advisers and Broker-Dealers 1 (2011).

[77] *Dole v. United Steelworkers of Am.*, 494 U.S. 26, 36 (1990).

[78] *Id.*

[79] *Webster's Third New International Dictionary* 2003 (1961) ("*Webster's Third*").

[80] *Id.* at 1780.

[81] *See, e.g.*, *Siegel v. SEC*, 592 F.3d 147, 158 (D.C. Cir. 2010) (explaining that self-regulatory organization rule was designed "to protect customers from potentially abusive sales practices by ensuring that a registered representative has reasonable grounds for believing that his recommendation is suitable" (internal quotation marks omitted)); *Frederick C. Gartz*, Exchange Act Release No. 37,556, 1996 WL 454822, at *1 (Aug. 12, 1996) ("Gartz engaged in fraudulent sales practices. Gartz recommended and sold direct investments to customers for whom the investments were not suitable . . . ."); FINRA Notice 09-31, at *1 ("This Notice reminds firms of their sales practice obligations in connection with leveraged and inverse ETFs. In particular, recommendations to customers must be suitable . . . ."); *see also A.S. Goldmen & Co.*, Exchange Act Release No. 47,037, 2002 WL 31840963, at *2 (Dec. 19, 2002) (describing prohibited sales practices as "an aggressive cold-calling campaign," "misrepresentations and omissions of material facts," and "baseless price predictions"); *Hunter Adams*, Exchange Act Release No. 52,662, 2005 WL 2756710, at *1 (Oct. 25, 2005) (identifying "sales practices" as certain "high pressure sales tac-tics"); Mary L. Schapiro, *Investor Protection: The Role of the*

This statutory context informs the meaning of the next two phrases in section 211(h)'s list: "conflicts of interest" and "compensation schemes." These terms refer to structural incentives that may encourage a broker-dealer or investment adviser to push an investor into an unsuitable transaction. As the Commission recognized in Regulation Best Interest, a paradigmatic example of a potentially undesirable compensation scheme is a sales quota or bonus.[82] These compensation schemes create potential "conflicts of interest" by fostering "high-pressure situations" for employees of broker-dealers and investment advisers to attempt to induce an investor to pick one "specific security over another," possibly employing aggressive sales practices in the process.[83]

The word "certain" preceding "sales practices, conflicts of interest, and compensation schemes" reinforces the limited nature of Congress's grant of rulemaking authority. The "certain" modifier "applies to the entire series."[84] And it demonstrates that Congress carefully delineated the Commission's rulemaking authority to proscribe discrete promotional practices, tactics, and compensation schemes that misalign the incentives of the regulated entities and the retail investors whom they advise.[85]

A broader reading of section 211(h) is inconsistent with surrounding provisions of the Act and the structure of the law Congress enacted. section 211(a) grants the Commission authority "to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this subchapter, including rules and regulations defining technical, trade, and other terms used in this subchapter."[86] That general authority, however, comes with an important caveat: The Commission "may *not* define the term 'client' for purposes of [sections 206(1)-(2)] to include an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser."[87]

Section 211(g), meanwhile, authorizes the Commission to regulate advisers' standard of conduct, but *only* "when providing personalized investment advice about securities *to retail customers* (and such other customers as the Commission may by rule provide)."[88] And were

---

SEC, the SROs, and the Industry in Preventing Sales Practice Abuses 3–4 (Oct. 9, 1992), https://www.sec.gov/news/speech/1992/100992schapiro.pdf (similar).

[82] *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86,031, 84 Fed. Reg. 33,318, 33,454 (July 12, 2019).

[83] *Id.*

[84] *Facebook, Inc. v. Duguid*, 141 S. Ct. 1163, 1169 (2021).

[85] *See El Al Israel Airlines, Ltd. v. Tsui Yan Tseng*, 525 U.S. 155, 173 (1999) ("Inclusion of the word 'certain' in the [Warsaw] Convention's title . . . accurately indicated that the [C]onvention is concerned with certain rules only, not with all the rules relating to international carriage by air." (second alteration in original) (internal quotation marks omitted)).

[86] 15 U.S.C. § 80b-11(a).

[87] *Id.* (emphasis added).

[88] *Id.* § 80b-11(g) (emphasis added).

that not clear enough, section 211(g) further prohibits the Commission from "ascrib[ing] 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."[89]

Taken together, these carve-outs in sections 211(a) & (g) make clear that the Commission cannot ground the Proposal in *retail* investor protection. The Commission cannot treat private fund investors (*e.g.*, pension funds), which are partners in the funds, as if they were retail customer beneficiaries (*e.g.*, individual pension fund beneficiaries). Those retail customers are not the partners in the funds, and their assets are protected by their own fiduciaries. In addition, the statutory carveouts establish that private fund investors are not the advisers' clients to whom the advisers owe fiduciary duties. Advisers are fiduciaries to the fund itself, not the investors in that fund. If section 211(h) could be read as expansively as the Commission is attempting here, the explicit carve-outs would be meaningless.

Yet treating the investors in a private fund as advisers' clients to whom advisers owe fiduciary duties is exactly what the Commission is trying to do in the Proposal, which completely elides the distinction between clients and their investors. This practice is evident in the general justifications. For example:

- "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."
- "This scope of prohibitions is appropriate because these activities harm investors by placing the adviser's interests above those of its private fund clients (*and investors in such clients*)."
- "We believe that this proposed requirement would provide an important check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit *at the expense of private fund investors and would help ensure that private fund investors are offered a fair price for their private fund interests*."[90]

The Commission treats investors in private funds as clients of the adviser in the actual rules themselves:

- Proposed Rule 275.211(h)(2)-2 prohibits advisers from completing an adviser-led secondary transaction "with respect to any private fund, unless the adviser obtains, and distributes to investors in the private fund, a fairness opinion from an independent opinion provider and prepares, and distributes *to investors in the private fund*, a written summary of any material business relationships."

---

[89] *Id.*

[90] Proposal at 16,889, 16,925, 16,964.

- Proposed Rule 275.211(h)(2)-3 prohibits advisers from certain preferential treatment practices "with respect to the private fund, *or any investor in that private fund*," and further requires advisers to "distribute *to current investors* … a written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund."[91]

This Proposal thus plainly attempts to regulate the conduct of advisers not merely vis-à-vis their clients (the funds), but with respect to their clients' investors—which is not materially different from imposing a fiduciary duty on fund advisers that runs directly to the investors. These attempts to smuggle in a duty to investors in a private fund are incompatible with the statutory scheme.

In fact, the D.C. Circuit rejected a similar Commission attempt in *Goldstein v. SEC*,[92] which invalidated the Commission's "Hedge Fund Rule."[93] Before 2006, advisers to hedge funds generally were not required to register under the Advisers Act, because (1) at the time, section 203 of the Advisers Act exempted advisers with 15 or fewer annual "clients,"[94] and (2) the Commission had long interpreted the term "client" in that provision to refer to the fund or entity, not its investors.[95] In the Hedge Fund Rule, however, the Commission reinterpreted "client" to include "the shareholders, limited partners, members, or beneficiaries of the fund," which had the effect of requiring most advisers to hedge funds to register with the Commission.[96] As a result of this approach, which "require[s] advisers to private funds to 'look through' the funds to count each investor as a client," the Commission predicted that "most hedge fund advisers would be required to register under the [Advisers] Act, thus extending the protections of the Act's registration provisions to these hedge fund *investors* and the securities markets in general."[97]

The D.C. Circuit in *Goldstein* rejected the Commission's "look-through" approach and struck down the rule because, in "equat[ing] 'client' with 'investor,'" the Commission had exceeded the authority the Advisers Act grants.[98] "Although the statute does not define 'client,' it does define 'investment adviser' as 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.'"[99]

---

[91] Proposal at 16,977.

[92] 451 F.3d 873 (D.C. Cir. 2006).

[93] 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279 (2006)).

[94] 15 U.S.C. §80b-3(b)(3) (2006).

[95] *Goldstein*, 451 F.3d at 876.

[96] *Id.* at 877.

[97] Br. for SEC, *Goldstein v. SEC*, No. 04-1434 (filed June 23, 2005) (emphasis added).

[98] *Id.* at 874.

[99] *Id.* at 879 (quoting 15 U.S.C. § 80b-2(11)).

And that definition does not describe what advisers do vis-à-vis individual investors in private funds: While "an investor in a private fund may benefit from the adviser's advice (or he may suffer from it)[,] he does not receive the advice *directly*"; instead, "[h]aving bought into the fund, the investor fades into the background; his role is completely passive."[100] Thus, the court held that in the private fund context, the structure of the Advisers Act confirms that the adviser's "client" is the fund, not its investors.[101]

The Proposal relies on the same "look-through" approach that the D.C. Circuit rejected in *Goldstein*. It "look[s] through" the private funds and extends restrictions with respect to the funds' investors. Indeed, on its face, the Proposal imposes a client-like relationship between advisers and private fund investors and plainly imposes *fiduciary* duties on advisers vis-à-vis private fund investors. That is squarely contrary to *Goldstein*, which stated that "[t]he adviser owes fiduciary duties *only to the fund*, not to the fund's investors."[102] Underlying that conclusion was not only the statute's text and structure, but also basic common sense: "If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest," and "[i]t simply cannot be the case that investment advisers are the servants of two masters in this way."[103] That principle applies equally here, and further demonstrates that the proposed rules are incompatible with the statutory structure Congress enacted.

The history of section 211(h) further illustrates that the provision does not sweep as broadly as the Commission claims, and is directed to certain practices by broker-dealers and investment advisers when recommending investments to investors, not to the terms of the investments themselves. As an initial matter, section 211(h) was added as part of section 913(g) of the Dodd-Frank Act. That provision is entitled "Authority to Establish a Fiduciary Duty for Brokers and Dealers," and it is focused almost exclusively on granting the Commission power to establish a standard of conduct as to *retail* customers. Moreover, at the same time it added section 211(h), Congress amended section 211(a) of the Advisers Act to make clear that advisers do *not* owe a fiduciary duty to private fund investors.[104] The legislative history confirms that the goal of this amendment was to "avoid[] potential conflicts between the fiduciary duty an adviser owes to a private fund and to the individual investors in the fund (if those investors are defined as clients of the adviser). Actions in the best interest of the fund may not always be in the best interests of each individual investor."[105] In short, while the Dodd-Frank Act authorized the Commission to promulgate rules for the enhanced protection of *retail* customers, it simultaneously prohibited the Commission from using that power to reshape the traditional understanding that private fund *investors* are not owed a fiduciary duty by the fund's advisers,

---

[100] *Id.*

[101] *Id.* at 879-81; *see also id.* at 880 (noting that the Supreme Court "embraced a similar conception of the adviser-client relationship" in *Lowe v. SEC*, 472 U.S. 181 (1985)").

[102] *Id.* at 881 (emphasis added).

[103] *Id.*

[104] Dodd-Frank Act § 406.

[105] S. Rep. No. 111-176, at 74 (2010).

who continue to owe their fiduciary duty to the fund, which may have interests that deviate from those of individual investors.

> Given that the Dodd-Frank Act both reaffirmed the elementary distinction between retail customers and investors in private funds, and erected further barriers to guard against the two-masters problem inherent in creating fiduciary duties to both the fund and the fund's investors, it would be doubly mistaken to conclude that the general language of section 211(h) authorizes the Commission to do what the specific language of sections 211(a) and (g) forbids.

That is particularly true given that the rest of section 913 of the Dodd Frank Act was plainly targeted at retail investors, not institutional investors. section 913 defined a single term: "retail customer."[106] It required the Commission to conduct "a study" of existing standards of care for brokers, dealers, and investment advisers when "providing personalized investment advice and recommendations about securities *to retail customers*" and to evaluate the need to fill any "gaps" in the "legal or regulatory standards" relevant to "the protection of *retail customers*."[107] It likewise gave the Commission authority to "commence a rule-making, as necessary or appropriate in the public interest and for the protection *of retail customers* (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care … for providing personalized investment advice about securities to such *retail customers*."[108] This latter provision (*i.e.*, section 913(f) of the Dodd-Frank Act) is almost identical in wording to section 211(h) of the Advisers Act, save for the explicit inclusion here of "retail customers."

Against this backdrop, it is telling, as well, that section 211(h) received no legislative debate whatsoever—a strong indication that members of Congress understood the provision to confer a limited rulemaking power to address promotional methods related to retail investors, not to force private funds "to restructure the[] fee and expense model[s]" available to their investors.[109] Congress did not hide this elephant in the mousehole of section 211(h)(2).[110]

b) The Proposed Prohibited-Activities Rules Do Not Prohibit Practices That Are Contrary To The Public Interest And The Protection Of Investors.

In addition, the Commission's proposed prohibited-activities rules fail to satisfy the other criterion in section 211(h)(2)—that the prohibited practice is "contrary to the public interest and the protection of investors." To begin, the vast majority of private fund investors are qualified purchasers, which, as discussed, can be assumed to be capable of protecting their own interests. The Commission has failed to make any showing that the Proposal is needed to protect such

---

[106] *See* Dodd-Frank Act § 913(a).

[107] *Id.* § 913(b)-(c) (emphases added).

[108] *Id.* § 913(f) (emphases added).

[109] Proposal at 16,922 n.157.

[110] *See Whitman*, 531 U.S. at 468.

investors. Further, the activities the Commission seeks to prohibit serve the public interest and investors alike. For instance, when investors are permitted to agree to indemnify an adviser for negligence, they may select a fund structure that does not constrain an adviser to be unduly cautious, for example in selecting illiquid investments or using levered capital structures. Likewise, permitting an adviser to pay clawbacks net of taxes permits an adviser to manage its liquidity efficiently. It is in the public interest, and for the protection of investors, to allow investors to choose these structures. The Commission does not have authority to micromanage the negotiated allocations of costs between sophisticated counterparties.

c) Section 206(4) Also Does Not Authorize The Proposed Prohibited-Activities Rules.

The Commission also appears to invoke section 206(4) as authority for the proposed prohibited-activities rules,[111] but section 206(4) no more justifies the proposed prohibitions than does section 211(h)(2). Again, section 206(4) authorizes the Commission to "define, and prescribe means reasonably designed to prevent," "acts, practices, and courses of business" that are "fraudulent, deceptive, or manipulative."[112] Here, however, the Commission failed to "define" the allegedly fraudulent acts, and failed to explain how the prohibition on fully disclosed activities agreed among parties represented by expert counsel would prevent those (undefined) acts.

Moreover, the Commission does not—and cannot—show that the proposed prohibitions are "reasonably designed." A broad, prophylactic prohibition that "may" deter some fraud because the prohibition sweeps so widely, capturing a range of primarily legitimate practices in the process, is not "reasonably designed" to prevent fraud. That is especially true here, where the Proposal generally concerns investments in private funds made by investors that are perfectly capable of protecting their own interests. And even if the existence of certain activities creates the possibility for misconduct, the activities are disclosed, and highly sophisticated investors can balance the costs and benefits for themselves of various fund terms and structures.

For example, how the proposed prohibition on entering into arm's-length indemnification provisions with sophisticated counterparties has a reasonable connection to preventing fraud is difficult to see. Such a prohibition might be justifiable as a prophylactic fraud-prevention rule with respect to *retail investors*, who typically do not negotiate advisory agreements and who typically lack sophistication and the advice of counsel. Private funds investors negotiate advisory agreements, and do so while assisted by expert counsel. This results in mutually beneficial arrangements and tradeoffs—for example, as noted, an adviser indemnified for negligence will be more likely to select strategies with greater returns, and an adviser who can pay clawbacks net of taxes can manage its liquidity more efficiently. In that context, the claim that the proposed indemnification prohibition is "reasonably designed to prevent" fraud is not credible.

---

[111] *See* Proposal at 16,920.

[112] 15 U.S.C. § 80b-6(4).

B. The Proposal Is Arbitrary And Capricious.

Even apart from the absence of statutory authority, the Proposal is arbitrary and capricious because it is unnecessary, ineffective, and counterproductive, inconsistent with past Commission policy, does not consider reasonable alternatives, fails to account for reliance interests, and affords the public no meaningful ability to comment.

1. The Proposal is unnecessary. The Commission's Proposal is a solution in search of a problem. The Proposal identifies no sound reason why it is suddenly necessary to impose a range of burdensome and transformative regulations on the private fund industry. As discussed, the vast majority of investors in private funds are presumed by law to be able to evaluate and appreciate the risks associated with their investments.[113] The Commission does not show that qualified purchasers are unable to protect their interests and make sound decisions regarding the terms of their investments in private funds, which are typically in tens or hundreds of millions of dollars, or even billions.

Nor could the Commission make such a showing. Although the Commission notes that the beneficiaries served by private funds are often everyday Americans saving for retirement,[114] the Commission ignores that the decisionmakers are highly sophisticated fiduciaries who, in negotiating investment terms, are often represented by highly sophisticated counsel. By way of example, an AIC member recently admitted more than 250 investors in a fund, who were represented by counsel from more than 25 law firms, and submitted nearly 50 comment memos with over 1,000 diligence items and specific demands for changes to fund terms. In response to these comments, diligence requests from investors, and contractual negotiation points, the adviser's law firm spent over 3,000 hours responding to diligence and negotiating terms that were acceptable to investors. This level of sophistication and negotiation is typical for the private equity fund business, and we believe that this process is indicative of a healthy market in which sophisticated investors are able to negotiate the specific responsibilities and compensation of their investment adviser.

Indeed, private funds have been around for decades, and highly sophisticated, qualified purchasers continue to choose this form of investment, which has amassed a strong track record of delivering positive high returns.[115] The increased interest of large, sophisticated investors in private funds is one of the most pronounced current investment trends.[116] All of this indicates that qualified purchasers are satisfied with the business model of private funds, and reinforces

---

[113] *Prohibition of Fraud By Advisers of Certain Pooled Investment Vehicles*, 2006 WL 3814994, at *8 n.45.

[114] Proposal at 16,887.

[115] *See* Kothari Report ¶ 22 ("Sophisticated investors have invested increasing amounts in private equity over the years.").

[116] *See* Hugh MacArthur, et al., *The Private Equity Market in 2021: The Allure of Growth*, Bain & Co. (Mar. 7, 2022), https://www.bain.com/insights/private-equity-market-in-2021-global-private-equity-report-2022/.

that the Commission is regulating in a field that has no market failure—or other deficiency—in need of correction.[117]

The Commission also asserts that "even sophisticated" investors have had difficulty evaluating private funds,[118] but in 2017 Preqin reported that investors rated "transparency" as the *lowest* "key challeng[e]" they face,[119] and, in 2022, when Preqin set out "private equity investor views on the key challenges for return generation" from 2019-2021, "transparency" was not reported as an investor challenge.[120] In any event, the only support the Commission cites for its proposition amounts to no support at all.[121] Seven years ago, a number of state treasurers and controllers wrote that the "cost structures of private equity are complicated."[122] The letter, however, acknowledges that private equity funds "generally disclose information on all types of fees," and confirms that when "comparing 10-year annualized returns, pension fund investments in private equity have outperformed other asset classes."[123] Moreover, the complaints of some treasurers and comptrollers are not representative of the broader market of private fund investors, or indeed of state or local pension funds, many of which are strong advocates of the asset class.[124]

Moreover, private equity managers' track record with the Commission and investors since registering under the Advisers Act beginning in 2012 following enactment of the Dodd-Frank Act[125] shows that the current regulatory system is functioning. Following the implementation of the Dodd-Frank Act in 2010, the Commission allocated resources to develop specific expertise with respect to private funds and advisers,[126] and specialized asset management and private fund units conducted an aggressive examination of the industry,[127] culminating in a number of enforcement actions against private equity managers. The private

---

[117] *See* Flannery Report ¶¶ 29-44.

[118] Proposal at 16,954; *see also id.* at 16,892 & n.24.

[119] *See* Preqin, *Investor Appetite for Private Equity in 2017*, Fig. 8.13 (2017).

[120] *See* Preqin *Investor Outlook: Alternative Assets H1 2022*, Fig. 3.12 (2022); *see also* Kothari Report ¶ 111 ("the increasing demand for private equity advisory services suggest[s] that investors are satisfied with the level of information provided to them").

[121] *See* Proposal at 16,892 n.24.

[122] Letter from State Treasurers and Comptrollers (July 21, 2015), https://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf.

[123] *Id.*

[124] *See* Kothari Report ¶¶ 22-27.

[125] *See generally* Dodd Frank Act; *see also id.* § 403.

[126] SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence, SEC Press Release (Jan. 13, 2010).

[127] "Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View," Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement (Feb. 26, 2015).

equity industry responded by modifying practices consistent with the Commission's enforcement and regulatory directives, including steps to cease certain practices, and the Commission staff recognized these changes.[128] Perhaps more importantly, during this time fund managers continued to negotiate new terms and arrangements at the request of investors, in part due to concerted efforts by investor advocacy groups such as ILPA. During this period, investors continued to allocate historic amounts of capital to private equity funds.[129] And in 2019, the Commission released its Advisers Act Fiduciary Interpretation that expressly acknowledged and preserved the ability of investment advisers to work with their sophisticated clients to tailor the scope of an adviser's fiduciary obligations. This chronology shows an industry that evolved with a changing market and a regulatory system that achieved the goals of the Commission and the Advisers Act, not a rogue industry motivated by excessive fees, conflicted transactions, and an unwillingness to negotiate with investors.[130]

2. The Proposal will create harmful, counterproductive consequences. As detailed below, the extensive additional reporting requirements contemplated by the Commission will be enormously costly.[131] This increased cost will decrease returns for all private fund investors and drive from the market smaller fund sponsors, who lack the back-office infrastructure needed to efficiently comply with the proposed reporting requirements.[132]

At the same time, the proposed prohibited-activities rules will create potentially counterproductive incentives for private fund advisers. Many investors rationally choose to limit the liability of private fund advisers so that advisers will be properly incentivized to take efficient risks, rather than passing up opportunities out of fear of potential litigation costs. By prohibiting investment advisers and investors from agreeing to limit an adviser's liability, the Proposal will, as the attached report by Professor Kothari explains, likely reduce advisers' willingness to pursue investments that involve calculated risks, which will have the inevitable impact of decreasing the returns for which private equity funds are currently highly valued.[133] The Proposal will limit investor choice and eliminate an incentive structure that many investors have found to work.

The proposed prohibited-activities rules would also, as the Commission itself admits, cause private fund advisers to "restructure their fee and expense model."[134] This restructuring

---

[128] "Private Equity: A Look Back and a Glimpse Ahead," Speech by Marc Wyatt, Acting Director, Office of Compliance Inspections and Examinations (May 13, 2015).

[129] Center for Retirement Research at Boston College, MissionSquare Research Institute, National Association of State Retirement Administrators, and Government Finance Officers Association. *Public Plans Data 2001-2020.*

[130] *See, e.g.*, Key Findings ILPA Industry Intelligence Report: What Is Market In Fund Terms? (2021), *available at* https://ilpa.org/wp-content/uploads/2021/10/Key-Findings-Industry-Intelligence-Report-Fund-Terms.pdf ("Clear and consistent reporting of fees and expenses is an area that has seen real progress.").

[131] *Infra* at 52-61; *see also* Kothari Report ¶¶ 52-54.

[132] *See* Kothari Report ¶¶ 14, 55; Flannery Report ¶ 52.

[133] Kothari Report ¶¶ 86-87; *see also* Flannery Report ¶ 6.

[134] Proposal at 16,922; *see also id.* at 16,920; Kothari Report ¶ 68.

would be costly in and of itself by forcing advisers to use a less efficient fee structure to recover their expenses, and it would raise costs in other ways. For example, advisers could seek to charge large, fixed management fees with sufficient cushion built in for any unexpected developments. Investors could thus end up paying more across the board.

3. The Proposal cannot be squared with other Commission actions. Just a few years ago, in 2019, the Commission recognized that the "relationship between an investment adviser and its client has long been based on fiduciary principles not generally set forth in specific statute or rule text," and "that this principles-based approach should continue."[135] In fact, the Commission explained that under this principles-based approach, a "hedge clause in an agreement with an institutional client" was not per se incompatible with an adviser's fiduciary duty to its client.[136] The Commission retreats from both of these conclusions, abandoning a principles-based system and categorically banning hedge clauses, without an adequate explanation of its change in position.[137]

The Proposal also cannot be squared with the Commission's longstanding position that its mission is not to protect investors from themselves, but rather to promote informed decision-making based on disclosures. As the Commission put it at the time of enactment of the 1940 acts: "If [a fund is] going to be a speculative investment trust, and they disclose that fact to their investors, and the investors want to invest in that type of investment company, who are we to say, 'No; you shall not invest in that type of company'?"[138] By prohibiting widely accepted contractual provisions freely adopted by counterparties negotiating at arm's-length, the Commission has abandoned its role as "a disclosure-based agency" in favor of being a "merit regulator."[139] That is inconsistent with Congress's deliberate choice in the Investment Company Act to exempt private fund advisers from that sort of onerous and costly regulation.[140]

---

[135] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669, 33,670 (July 12, 2019).

[136] *Id.* at 33,672 n.31. A hedge clause is a provision in an advisory contract that limits the adviser's liability.

[137] *See Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2126 (2016) ("'[u]nexplained inconsistency' in agency policy is" a "reason for holding an interpretation to be an arbitrary and capricious change from agency practice"); *see also Goldstein*, 451 F.3d at 883 (vacating agency decision that "failed adequately to justify departing from its own prior interpretation").

[138] Investment Trusts and Investment Companies: Hearings Before the Subcomm. on Sec. & Exch. of the S. Comm. on Banking & Currency, 76th Cong. 233 (1940) (statement of David Schenker, Chief Counsel, SEC).

[139] Paul. S. Atkins, Comm'r, U.S. SEC, Recent Experience with Corporate Governance in the USA (June 26, 2003), 2003 WL 21515877, at *5 (the Commission "is a disclosure-based agency, not a merit regulator"); *see also, e.g.*, Securities Act Release No. 598, 1935 WL 28958, at *1 (Dec. 10, 1935) ("The Commission wishes to take this occasion to emphasize again that registration of a security does not imply quality of merit. The Commission is an office for the registry of information on securities. It does not pass on the merits of securities."); Harvey L. Pitt, Chairman, U.S. SEC, Testimony Concerning Financial Literacy (Feb. 5, 2002), 2002 WL 198062, at *2 ("Ours is a disclosure-based system. And it is our job to promote clear, accurate and timely disclosures—proactively."); Laura S. Unger, Comm'r, U.S. SEC, Securities Law and the Internet (July 28, 2000), 2000 WL 1161254, at *2 (the Commission is "a disclosure-based agency").

[140] *See also* Flannery Report ¶¶ 45-50.

4. The Commission has failed to give adequate consideration to reasonable, less restrictive alternatives. The Commission admits that it "lack[s] … data on the extent to which advisers engage in certain of the activities that would be prohibited under the [Proposal]" and that it is "difficult to quantify the benefits of these prohibitions" due to "a lack of data regarding how and to what extent the changed business practices of advisers would affect investors."[141] Since the Commission does not currently know if the prohibited practices have caused any harm, it could instead assess whether there is any evidence that any of the prohibited practices contributed to any misconduct that it finds through the regulatory examinations it conducts in the future. Based on these assessments, the Commission could at a future point make a more informed assessment of what are now entirely conjectural proposals.

We appreciate the Commission requesting comment on whether, instead of prohibiting these activities outright, the rule should prohibit them unless the adviser satisfies certain governance and disclosure conditions. While this approach would be far preferable and in keeping with the principles-based nature of the Advisers Act, [142] the Commission appears to discount it, suggesting that "many of the [targeted] practices are deceptive and result in obscured payments, and so may be used to defraud investors even if detailed disclosures are made."[143] This conclusion is speculative and forms an insufficient basis for the Commission to deviate from its historical approach of disclosure in favor of per se prohibitions. Again, investors in private funds are fully capable of understanding the disclosed risks and tradeoffs associated with various investment terms and structures; the Commission should let them choose for themselves.

5. The Commission did not adequately consider the investments that market participants have made in reliance on the status quo. The Proposal's mandates would upend the private funds industry.[144] Many "closed-end" private funds (*e.g.*, private equity funds) generally have a lifespan of eight to twelve years. If the rules are applied to existing funds, the investor agreements would need to be renegotiated—an enormously costly, massively disruptive endeavor. [145] Moreover, the mandatory renegotiations would disadvantage funds at different stages in the fund lifecycle—arbitrarily harming some investors and advisers more than others simply because of the timing of the rules.

6. The Commission has not given the public a meaningful ability to participate in this rulemaking. The APA requires agencies to afford the public an opportunity to meaningfully comment on proposed rules.[146] Yet here, the Commission has proposed a number

---

[141] Proposal at 16,948.

[142] *See* Flannery Report ¶ 72.

[143] Proposal at 16,959.

[144] The Commission "must … be cognizant that longstanding policies may have 'engendered serious reliance interests that must be taken into account.'" *Encino Motorcars, LLC*, 579 U.S. at 221-22 (quoting *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009)).

[145] *See* Kothari Report ¶ 54.

[146] *See Conn. Light & Power Co. v. Nuclear Regulatory Comm'n*, 673 F.2d 525, 528 (D.C. Cir. 1982) ("The process of notice and comment rule-making is not an empty charade. It is to be a process of reasoned decision-

of incredibly complex, massively consequential rules—all at the same time—and given the public abnormally short, 30-day comment windows to participate in these interrelated rulemakings. In these circumstances, it is not feasible for market participants and other members of the public to meaningfully participate in the Commission's pending rulemakings—as has been forcefully explained to the Commission by numerous commenters who are struggling to exercise their rights under the APA to participate in these consequential rulemakings, and to provide the information that the Commission itself has repeatedly said *it needs* in order to properly consider all important aspects of what it is proposing.[147] The Commission's current approach gives the impression of an unseemly rush toward a predetermined conclusion rather than the thoughtful consideration of potential flaws, objections, evidentiary gaps, and alternatives that the law requires.

In fact, a bipartisan group of 47 members of Congress has urged the Commission to extend the comment period to 90 days, explaining that a 30-day comment period does not permit the public to effectively evaluate and comment on the Proposal.[148] There is no reason to ignore this very reasonable request.

The Commission has compounded these problems by offering a multitude of alternative proposals in questions in each rulemaking proceeding.[149] Market participants cannot focus on every conceivable variation of the Proposal. Indeed, there are so many questions raising the possibility of so many potential changes to the Proposal that the AIC and other market participants lack sufficient notice of which, if any, of these changes would be made. Furthermore, the proposed changes would need to be considered in conjunction with other provisions of the Proposal, and would need to be included in a cost-benefit analysis on which the AIC and other members of the public can comment.

For all these reasons, if the Commission wishes to adopt a rule that deviates in an important way from the core proposal or includes any additional restrictions suggested in the Proposal's questions, the Commission must reissue a revised proposal, clearly articulate what the Commission is actually considering, and reopen the comment period. With commenters given a 30-day comment period, a reviewing court will be especially skeptical of significant changes claimed to be the "logical outgrowth" of a passing question included in a tide of regulatory proposals.[150]

---

making. One particularly important component of the reasoning process is the opportunity for interested parties to participate in a meaningful way in the discussion and final formulation of rules.").

[147] *See* Letter from Alternative Credit Council, et al. to The Hon. Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n (Apr. 5, 2022).

[148] Letter from 47 Members of Congress to The Hon. Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n (Apr. 13, 2022).

[149] *See, e.g.*, Proposal at 16,898 ("what additional disclosures are necessary"; "[s]hould we require advisers to report a consolidated "top-line" number that covers all covered portfolio investments," etc.).

[150] *See CSX Transp., Inc. v. Surface Transp. Bd.*, 584 F.3d 1076, 1079-83 (D.C. Cir. 2009) (vacating final rule because it was not a "logical outgrowth" of proposed rule).

C. The Proposal Is Unduly Costly And Not Consistent With The Commission's Statutory Duty To Promote Efficiency, Competition, And Capital Formation.

The Commission "has a unique obligation to consider the effect of a new rule upon 'efficiency, competition, and capital formation.'"[151] The Commission's "failure to 'apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation' makes promulgation of the rule arbitrary and capricious and not in accordance with law."[152]

Here, the Commission's analysis of efficiency, competition, and capital formation is inadequate because it does not "make any finding on the existing level of [efficiency, competition, and capital formation] in the marketplace."[153] The Commission, for example, admits that it is unable to quantify the "extent to which advisers currently provide information that would be required to be provided under the proposed rule to investors."[154] Therefore, the Commission "could not accurately assess any potential increase or decrease" in efficiency, competition, or capital formation because the Commission does not know "the baseline level" under the existing regime, making it impossible to make a reasoned assessment of any change.[155] In short, the Commission has not established a need for its rule, nor has it compiled an adequate record to support it.

In truth, moreover, the Proposal, on balance, tips entirely against efficiency, competition, and capital formation. As explained in the expert reports of Dr. S.P. Kothari and Dr. Flannery submitted with this comment, the Proposal will eliminate investment options and depress advisers' entrepreneurialism. This will stifle competition in the private fund market and deter capital formation.[156] The Proposal's massive costs will exacerbate the problem.[157] As smaller funds leave the market,[158] competition will further decrease, continuing to limit investment options.[159] At the same time, remaining funds will face higher costs, which will lead to lower investment returns, further deterring capital formation. And so, by increasing costs and discouraging risk-taking, the Proposal would reduce investment and returns in one of the most vibrant segments of the financial services industry, and one that is increasingly relied upon by state and corporate pension systems to meet investment return demands. In part because of the regulatory costs imposed on public companies, among others, investment today is shifting

---

[151] *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (quoting 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c)).

[152] *Id.* (quoting *Chamber of Commerce of U.S. v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005)).

[153] *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010).

[154] Proposal at 16,944.

[155] *Am. Equity Inv. Life Ins.*, 613 F.3d at 178.

[156] *See* Kothari Report ¶¶ 12-13, 21, 24-27; Flannery Report ¶¶ 52-53.

[157] *See* Flannery Report ¶¶ 6, 51-55, 65; *see* Kothari Report ¶¶ 52-54.

[158] *Infra* at 34, 42, 60.

[159] *See* Kothari Report ¶¶ 51, 55.

toward private capital—the Proposal would obstruct that trend through needless "protections" for some of the world's largest capital pools and investors. The loss would be borne not just by those investors and private fund advisers, but also by the beneficiaries of those investors and the companies they fund and support—which are a critical engine for innovation, job creation, and capital formation in the U.S. economy.

D. The Commission Cannot Lawfully Apply The Proposal To Existing Contracts.

Finally, if the Commission proceeds to a final rule despite all the concerns discussed above, that rule must not apply to existing provisions of negotiated contracts between investors and advisers. Even if such a rule "operat[ed] only from [its] passage," the rule would still fall within the "ban on retrospective legislation" because it would "affect vested rights and past transactions."[160] Because such "settled expectations should not be lightly disrupted," "the presumption against retroactive legislation is deeply rooted in [American] jurisprudence."[161] When it comes to agency rules, the presumption against retroactivity means that (1) "a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms," and (2) "administrative rules will not be construed to have retroactive effect unless their language requires that result."[162]

Here, the presumption against retroactivity cannot be overcome. Neither section 211(h) nor 206(4) of the Advisers Act expressly gives the Commission the power to promulgate retroactive rules. Section 211(h) authorizes the Commission to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes," but says nothing about whether such rules can prohibit or restrict these practices retroactively in contracts fully negotiated and executed prior to adoption.[163] Section 206(4) likewise is silent on whether the Commission's "reasonably designed [means] to prevent … acts, practices, and courses of business as are fraudulent, deceptive, or manipulative" can apply retroactively to existing contractual arrangements.[164] Nor does the language of the Proposal itself make clear that the proposed rules are to nullify existing provisions of negotiated contracts. The Proposal therefore cannot be read to have retroactive effect and would exceed the Commission's statutory authority to the extent they are intended to have retroactive effect.

In addition, the Proposal would violate the Fifth Amendment's Due Process Clause if it were to be applied retroactively. Retroactive laws violate due process unless "the retroactive

---

[160] *Landgraf v. USI Film Prods.*, 511 U.S. 244, 269 & n.23 (1994); *see also id.* at 280 (law has "retroactive effect" if "it would impair rights a party possessed when he acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed").

[161] *Id.* at 265; *see also Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988) ("Retroactivity is not favored in the law.").

[162] *Bowen*, 488 U.S. at 208.

[163] 15 U.S.C. § 80b-11(h)(2).

[164] *Id.* § 80b-6(4).

application of the [law] is itself justified by a rational legislative purpose."[165] Applying these proposed rules to existing, negotiated contracts between highly sophisticated parties is irrational for the reasons explained elsewhere in this comment. In particular, mandatory renegotiations of investor agreements would be a very costly and disruptive undertaking without any countervailing benefits.[166] Nor would the Proposal advance the Commission's own stated goals, as advisers and investors will ultimately renegotiate many of the same terms under less efficient structures.[167] Finally, retroactive application of the Proposal would at minimum be arbitrary and capricious under the APA, since the retroactivity would unduly upset entrenched reliance interests and investment-backed expectations of the investors in and advisers of (by the Commission's own count) the more than 80,000 private funds (including feeder funds).[168] Private equity funds typically have a lifespan of eight to twelve years. If the rules are applied to existing funds, the investor agreements would need to be entirely renegotiated—an enormously costly, massively disruptive endeavor that would arbitrarily disadvantage funds at different stages in the fund lifecycle.

Indeed—and critically—the Commission has failed to appropriately consider the immense costs that investors and private fund advisers would incur if the Proposal were to apply to existing agreements. As discussed, private equity and private credit funds typically have a lifespan in the range of eight to twelve years (with additional one- or two-year extension periods). The Commission places no weight on the fact that existing fund documents do not ordinarily provide for this kind of overhaul of fund terms and disregards the fact that, as a result of this regulatory change, advisers will be required to renegotiate terms with investors almost as if from scratch. To be clear, if the proposal is adopted as is, the entire industry, affecting more than 80,000 private funds, will be required to renegotiate their fund agreements. This will be a massive endeavor and impose astronomical costs on advisers and investors alike, almost none of whom would have had any notice of this cost at the time that they executed their agreements. Many of these costs will be borne by investors. Advisers, too, will bear a significant operational burden. They will be required to devote substantial resources—resources that would ordinarily be spent focusing on generating returns for funds—to a complete overhaul of documentation and commercial terms. In certain cases, for example where renegotiation of an existing fund's terms does not seem feasible, an adviser would be incentivized to terminate the fund early (at the expense of investor returns) and raise a new vehicle with higher fees. The Proposal will upset economic agreements industry-wide. It will not, as the Commission seems to believe, simply cause advisers to make discrete changes to specific terms in fund documents.[169]

---

[165] *Pension Ben. Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 730 (1984).

[166] *See supra* at 23.

[167] *See id.*

[168] *See supra* at 25-26; Proposal at 16,935.

[169] *See* Kothari Report ¶¶ 19, 49, 54, 77, 83, 126.

II. NUMEROUS SPECIFIC PROVISIONS IN THE PROPOSAL ARE UNNECESSARY AND UNDULY BURDENSOME.

As demonstrated above, the Proposal as a whole is unwarranted and unauthorized; it should be withdrawn. The discussion that follows addresses in depth the flaws of a number of specific provisions of the Proposal, including its prohibitions on indemnification provisions, on certain fee and expense terms, and on claw-back limitations; its disclosure requirements; its adviser-led secondary transaction rules; and its audit mandate. Independently and as a whole, these new requirements would generate needless cost and disruption in a sector of the financial services industry uniquely characterized by participants' capacity to pursue their own economic interests, and by the industry's success in generating attractive investment returns. Indeed, private fund investors consist of extraordinarily wealthy and sophisticated entities, including sovereign wealth funds and the world's largest pension funds. The following is a listing of the top private fund investors in 2021, ranked according to the market value of investors' private equity investment portfolios both through third-party managed investment vehicles and direct investments:[170]

[170] *See Global Investor 100 2021: The full ranking* (July 1, 2021), *available at* https://www.privateequityinternational.com/global-investor-100-2021-the-full-ranking/.

2021 Rank	Institution Name	Headquarters	Allocation (%)	Allocation ($m)
1	CPP Investments	Toronto	23.78%	88,677
2	Caisse de dépôt et placement du Québec	Québec	17.80%	51,010
3	GIC Private Limited	Singapore	13.00%	46,800
4	APG	Amsterdam	6.00%	41,747
5	Hong Kong Monetary Authority	Hong Kong	6.32%	34,152
6	Ontario Teachers' Pension Plan	Toronto	19.18%	32,774
7	California Public Employees' Retirement System	Sacramento	6.96%	30,800
8	National Pension Service of Korea	Jeollabuk-do	4.01%	30,688
9	Washington State Investment Board	Olympia	23.13%	29,558
10	California State Teachers' Retirement System	Sacramento	10.34%	29,306
11	Abu Dhabi Investment Authority*	Abu Dhabi	5.00%	28,981
12	Teacher Retirement System of Texas	Austin	14.86%	26,287
13	New York State Common Retirement Fund	Albany	9.80%	24,275
14	Allianz Global Investors	New York	3.18%	22,622
15	Oregon Public Employees' Retirement System	Tigard	23.49%	19,250
16	PSP Investments	Ottawa	14.13%	18,817
17	Japan Post Bank	Tokyo	0.88%	18,674
18	Pensioenfonds Zorg en Welzijn	Zeist	5.90%	18,318
19	Australia Future Fund	Melbourne	13.45%	17,715
20	BCI	Victoria	11.01%	17,248

21	State of Michigan Retirement Systems	Lansing	20.30%	17,093
22	Aberdeen Standard Investments	Aberdeen	4.45%	15,304
23	Florida Retirement System Pension Plan	Tallahassee	7.50%	13,730
24	Virginia Retirement System	Richmond	14.10%	12,986
25	Yale University	New Haven	41.62%	12,986
26	The Wellcome Trust	London	29.02%	12,924
27	International Finance Corporation	Washington, DC	19.61%	11,700
28	Alaska Permanent Fund	Juneau	15.76%	11,647
29	Ontario Municipal Employees Retirement System	Toronto	14.00%	11,526
30	Korea Investment Corporation	Seoul	6.30%	11,511
31	Massachusetts Pension Reserves Investment Management Board	Boston	12.60%	10,949
32	Stanford Management Company	Stanford	26.48%	10,838
33	MN	The Hague	5.00%	10,700
34	Ohio Public Employees Retirement System	Columbus	10.67%	10,500
35	Princeton University Investment Co.	Princeton	39.30%	10,454
36	New York State Teachers' Retirement System	Albany	7.70%	10,380
37	Temasek Holdings	Singapore	4.67%	10,000
38	Manulife Investment Management	Toronto	2.70%	9,653
39	Harvard Management Company	Boston	23.00%	9,637
40	Northwestern Mutual	Milwaukee	3.10%	9,572
41	Maryland State Retirement and Pension System	Baltimore	14.90%	9,318
42	New Jersey Division of Investment	Trenton	10.86%	9,191
43	State of Wisconsin Investment Board	Madison	6.38%	9,176

A. Prohibition On Certain Limitations Of Liability.

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 by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to a private fund.

This prohibition is a solution in search of a problem. The Commission cites no evidence of actual investor harm resulting from a private fund contractually limiting its liability in the manner targeted by the Proposal. The Commission is thus proposing to wipe away a contractual provision that for years has been widely adopted by sophisticated parties in arm's-length negotiations, with no evidence that any change is necessary. Even more remarkably, the Commission would do this just two-and-a-half years after issuing its Fiduciary Interpretation, which acknowledged and preserved the benefits of the current system for achieving contract terms through arm's-length negotiation between sophisticated counterparties.[171]

There is a reason the Commission cites no instances of actual harm resulting from the indemnification provisions it targets: Those provisions are invariably accompanied by separate contract terms that serve to align the interests of advisers and the private fund. Fund documents ordinarily require, for example, that the adviser (most often through the general partner or alongside the fund) commit its own capital to the fund, to align interests and balance the risk and reward profile. Similarly, advisers are incentivized to act for the benefit of the fund by receiving (through the general partner) carried interest (which is subject to a clawback, which is, in turn, often personally guaranteed by individual carried interest recipients). Advisers have powerful reputational incentives to act prudently because they know the industry is highly competitive and unconcentrated. Even the largest private fund sponsors are responsible for a small percentage of the market share. Investors in this sector will decline to invest in future funds with a sponsor that they—and other investors—have concluded cannot be trusted. Put simply, advisers about whom such judgments are formed do not survive.

The Commission cannot expunge widely used exculpation and indemnification provisions without taking proper account of these other means by which investors' and advisers' agreements incentivize proper conduct. Nor can the Commission disregard the purpose and function of indemnification and exculpatory provisions, which are closely negotiated by advisers and investors to enable fund advisers to efficiently manage their litigation risk—and to enable investors to foster the appropriate level of entrepreneurial spirit in their advisers. Without indemnification provisions, advisers may fear second guessing and be deterred from making certain investment decisions that align with a fund's strategy and could benefit the fund. Advisers may also be unwilling to take other calculated risks or pursue certain strategies, at least without increasing fixed costs for investors, such as management fees or insurance premium expenses. The Commission has recognized these concerns in the past, acknowledging, for instance, that without some protection against liability for "mere negligence," fiduciaries would be hampered in their decision-making and potentially discouraged from even serving in that capacity.[172] Liability protections can be particularly important in circumstances where more

---

[171] In considering whether to prohibit so called "hedge clauses," the Commission in the Fiduciary Interpretation declined to do so, despite its skepticism that a hedge clause would ever be appropriate for a retail client, stating that [t]he question of whether a hedge clause violates the Adviser's Act antifraud provisions depends on all of the surrounding facts and circumstances, including the particular circumstances of the client (*e.g.*, sophistication)." Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669 at n.31 (July 12, 2019).

[172] *See* Interpretive Matters Concerning Independent Directors of Investment Companies, 64 Fed. Reg. 59877 (Nov. 3, 1999).

hands-on engagement in the operation of an investment by the adviser is valuable, as in the case of a non-performing portfolio company, an illiquid investment, or an early stage, unproven business. The fund benefits in these circumstances from more active involvement by the adviser, yet if this Proposal is adopted, private fund advisers will be forced to devote resources and attention to the second-guessing of their judgment in costly litigation that will naturally follow.

For these and other reasons, and depending on the circumstances, private fund documents typically include provisions that indemnify the adviser for simple negligence, yet subject the adviser to potential liability under state law for gross negligence and more severe misconduct. We urge the Commission to recognize that provisions regarding indemnification and exculpation have evolved and continue to evolve as commercial considerations change. Sophisticated investors have demonstrated their ability to negotiate with investment advisers regarding these provisions and other fund terms.

As suggested above, the extent of the indemnification can vary with the characteristics of the private fund. For example, investors in a fund with higher-risk strategies are more likely to agree to indemnification and exculpation to give the adviser the flexibility to pursue the strategy effectively. In other cases, the adviser and investors may agree that more limited indemnification or exculpation is warranted. Advisers are unwilling to pursue certain strategies, however, without being able to freely negotiate liability provisions, at least without increasing fixed costs for investors such as management fees or insurance premium expenses.

Importantly, one consequence of the Proposal would be to force advisers to obtain additional "errors and omissions" ("**E&O**") insurance that covers negligent acts of the type the Commission would include in the prohibition. But the coverage, price, and availability of this insurance would be expected to change significantly from what advisers purchase today. Insurance premiums will likely increase materially (and, in certain cases, to prohibitive levels), without the assurance achieved by current liability limitations.[173] Moreover, such insurance may not even be available with the demand that could be set off by imposing a negligence standard on thousands of advisers.

Another potential consequence of the Proposal is a disproportionate impact on smaller and emerging funds, as investment professionals or principals who could be held personally liable migrate to larger firms with deeper pockets to protect them from the costs and hazards of litigation.

The Commission fails to give appropriate weight to these market realities. It also has not tailored the Proposal to the objective it seeks to achieve. According to the Commission, the proposed rule would "prohibit an adviser from seeking indemnification for breaching its

---

[173] We understand that insurance providers are discussing what the Proposal would mean for the insurance markets, because the availability of this insurance for private fund advisers is limited and increased demand would result in significantly higher prices if all advisers were required to obtain it. Compared to RICs, E&O insurance for private funds is more complicated due to private funds' complexity and variety. In addition, insurance premiums today reflect the existence of the indemnification and exculpation provisions that the Proposal would prohibit, further raising costs.

fiduciary duty… [and] would also prohibit an adviser from seeking reimbursement for its *willful malfeasance*."[174] But concern with violations of fiduciary duties or willful malfeasance does not justify barring indemnification for simple *negligence*, as the Proposal does. The Proposal nowhere provides a legal or policy basis for including negligence in the conduct that may not be indemnified or exculpated; in fact, other than in brief summaries of the proposed rule, the term "negligence" does not appear at all in the Proposal.[175]

To be clear, the AIC is not suggesting that advisers should be permitted to negotiate a blanket waiver of their fiduciary duties under the Advisers Act. Section 206 of the Advisers Act "establishes 'federal fiduciary standards,'" and section 215 provides that those duties cannot be waived.[176] The Commission has authority to enforce them.[177] Other limitations on advisers' conduct exist as well, such as the implied covenant of good faith and fair dealing under Delaware law and similar standards under the law of the Cayman Islands and other jurisdictions in which private funds are commonly formed. Those standards are part of the legal backdrop against which fund advisers and their sophisticated investors mutually agree on the desired level of exculpation and indemnification—an "important aspect of the problem"[178] that the Commission ignores.[179]

What the Commission may not do, however, is effectively mandate a private right of action for damages, achieving indirectly what it cannot do directly. The Supreme Court has made clear that the remedies available in a private right of action under the Advisers Act are limited to rescission, restitution, and injunction[180]—the Commission has no power, under that same Act, to assure investors of a right of action that Congress chose not to confer. Nor may the Commission effectively codify a negligence action for private fund investors when Congress has made clear that even retail investors are not entitled to the same right of action. Under section 17(i) of the Investment Company Act, a RIC may not indemnify an investment adviser for 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 its obligations and duties.[181] Thus, pursuant to

---

[174] Proposal at 16,925 (emphasis added).

[175] To the extent the SEC believes a claim for negligence is needed for investors to enforce, through the courts, the fiduciary duty investment advisers owe under the Advisers Act, that conclusion is simply mistaken—in a state law negligence suit, the court applies a negligence standard; it does not adjudicate whether the investment adviser violated its Advisers Act fiduciary duties. Conversely, an Advisers Act fiduciary breach claim adjudicates just that—negligence is not the standard.

[176] *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) ("**Transamerica**").

[177] *See id.* at 20; *see also Robare Grp. v. SEC*, 922 F.3d 468, 473 (D.C. Cir. 2019).

[178] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 US 29 (1983).

[179] For example, negotiated provisions of fund partnership agreements often limit indemnification and exculpation for willful, material breaches of fiduciary duty or for reckless disregard of duties, in addition to gross negligence and willful malfeasance.

[180] *Transamerica*, 444 U.S. at 24.

[181] Section 17(i) of the Investment Company Act generally prohibits a fund from including in its advisory agreement any provision that protects an adviser against any liability to the fund or its shareholders by reason of willful misfeasance, bad faith, gross negligence, or reckless disregard in the performance of its obligations and

direct Congressional authority under the Investment Company Act, a RIC may indemnify its investment adviser for negligence. Section 3(c)(7) of the Investment Company Act was enacted to specifically exclude vehicles with sophisticated investors from the regulatory rubric applicable to RICs.[182] It makes no sense, then, to subject a section 3(c)(7) vehicle to even higher conduct standards than those applicable to a RIC, as the Commission proposes. Most private fund investors have negotiated exculpation and indemnity carve outs that equal or exceed the standard for RICs. Moreover, retail investors purchase interests in public operating companies that typically indemnify directors for negligence, breach of fiduciary duty, willful misfeasance, and certain other conduct. And, accredited investors, who are subject to a lower sophistication standard than qualified purchasers, may purchase interests in a private placement in which the issuer may indemnify its general partner or managing member for negligence, gross negligence, or breach of fiduciary duty. In yet another inconsistency with the Proposal, any investor suing under section 10(b) of and Rule 10b-5 under the Securities Exchange Act of 1934 (the "**Exchange Act**") must prove that the defendant acted with scienter (*i.e.*, an intent to defraud).[183] Against this backdrop, and the precedent in *Transamerica*, it is plain that requiring investment advisers to be liable to private litigants for mere negligence or breach of duty that is neither willful nor material is arbitrary and is irreconcilable with the text and structure of the securities laws.

* * *

Having appropriate freedom to exercise their judgment and discretion has been an important component of private fund advisers' ability to generate greater returns than investors typically experience in other asset classes. Investors benefit from the protections that the Commission, with its enforcement authority under the Advisers Act, offers the fund, while also having a contractual right of action (most often in the case of the adviser's gross negligence or more harmful conduct). By entirely banning such indemnification clauses, even for mere negligence, the Commission would eliminate an agreed-to term that has been instrumental in the growth of private capital. The result would be manifestly contrary to the public interest, as a segment of the investment industry that has been largely free of conflict between investors and managers would be suddenly opened wide to the waste and distraction of litigation.

---

duties. 15 U.S.C. § 80a-17(i); *See also* Interpretive Matters Concerning Independent Directors of Investment Companies, 64 Fed. Reg. 59877, (Nov. 3, 1999)." (Interpreting the similarly worded standard in section 17(h) regarding director indemnification. None of the Commission's statements regarding either of these provisions have ever suggested that negligent errors or mistakes undertaken in good faith are included in the statutory prohibitions on indemnification and exculpation that apply to advisers to RICs).

[182] Privately Offered Investment Companies, 62 Fed. Reg. 17512 (Nov. 3, 1999) at 17515 ("the legislative history suggests that the asset should be held for investment purposes and that the nature of the asset should indicate that its holder has the investment experience and sophistication necessary to evaluate the risks of investing in unregulated investment pools"). *See also* U.S. Sec. & Exch. Comm'n., *Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission* 13 (2003) ("This exclusion reflects Congress's view that certain highly sophisticated investors do not need the protections of the Investment Company Act because those investors are in a position to appreciate the risks associated with pooled investment vehicles.").

[183] *See e.g. Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199, 214 (1976)

B. Certain Prohibited Fees And Expenses, Prohibition On Non-Pro Rata Allocations.

The Proposal prohibits certain fee and expense terms and practices that have been a historic feature of many private funds, including private equity funds in particular. *First*, the Proposal prohibits accelerated payments by private fund portfolio companies of monitoring, servicing, consulting, or other service fees to an adviser where the adviser does not, or does not reasonably expect to, provide the related services to the company, unless the private fund terms include a 100% offset of such amounts against the adviser's management fees or otherwise pass on the benefit of the accelerated fees to the private fund. *Second*, the Proposal prohibits an adviser from charging or allocating fees and expenses related to an actual or potential portfolio investment on a non-pro rata basis, when multiple private funds and other clients of the adviser or its related persons are (or would be) invested in the same investment.

These proposed prohibitions, which seek to regulate economic terms that are the subject of regular and active negotiation by advisers and sophisticated investors, are inappropriate and would harm the industry. Investors consider the overall package of economic and related terms of a private fund (as clearly set out in its governing documents) when considering investment in a fund, taking into account many variables specific to the adviser, the investors, and the fund itself. Imposing blanket prohibitions on certain economic terms limits the flexibility of advisers and investors to arrive at overall economic terms that are appropriate to the specific investment opportunity and mutually acceptable to the parties.

Monitoring, servicing, and consulting fees and fees for services not reasonably expected to be performed. It is of course understandable why the Commission would seek to prohibit clauses in contracts providing for payment for services that are not capable of being provided, but that is not at all what the Proposal says. Even accelerated monitoring fees can be structured in a manner in which future services are contemplated to be provided, and the Proposal is not even limited to accelerated monitoring fees. Instead, if this rule is adopted as proposed, it would apply more broadly to "servicing, consulting, or other fees" in respect to "any" services that the investment adviser does not, or does not "reasonably expect" to provide. This test is subjective and will fuel claims that fees are not proportionate to the services rendered, as opposed to fees for services that are not rendered at all. Particularly where contracted-for services are performed over time or as needed, there is a high-likelihood that an adviser will be "second-guessed" by the Commission's examiners as to whether the performance was delivered and charged appropriately for purposes of the rule.

The industry responded to investor's concerns about monitoring fees over the last two decades. In the early 2000s, for example, the market standard was to offset 50-80% of monitoring fees against a fund's management fee. Today, the overwhelming market practice is for funds to offset 100% of monitoring fees against management fees. This shift is illustrative of two important points. *First*, the Commission's focus on monitoring fees is unnecessary. *Second*, and critical to how the Commission should view private funds in general—investors have shown that they are fully equipped to cause a shift in market terms without regulatory intervention.

The prohibition on fees for services not reasonably expected to be performed is overly broad. An investor in a large fund sponsored by a well-established adviser may—as the Proposal supposes—be unwilling to agree to the prohibited expenses, based on its view that the management fees earned from the fund should be sufficient compensation for the adviser. But the same investor might take a different view when investing with a new fund sponsor or in a first-time fund being launched by an established sponsor, in recognition that if certain expenses are not passed through, the only viable option for the adviser would be increased management fees.

Mandatory pro rata allocation of expenses. The prohibition on non-pro rata allocations of expenses across clients inappropriately overrides an adviser's own judgement of how to best discharge its fiduciary duties in allocating expenses. Suppose, for example, that an adviser has engaged in diligence that benefits more than one of its fund clients but is clearly more beneficial to, or driven more by the needs of, one fund in particular. The Commission and its staff have historically agreed that, in that circumstance, it would be consistent with the adviser's fiduciary duty for the adviser to charge the expense on a non-pro rata basis, allocating most or all of the expense to the fund that was the principal beneficiary or the impetus for the diligence. As another example, a particular private fund and its investor base may have commercial or legal issues that are not relevant to other private funds participating in the transaction, such as tax issues or regulatory concerns arising under local "foreign investment" regulations that are only relevant to that fund. In such cases, an adviser should be able to conclude, in keeping with its fiduciary duties, that it is not fair or equitable for all participating funds to bear the costs equally. For example, an ERISA plan administrator or trustee is subject to a fiduciary duty and is thus required to act in accordance with a duty of prudence and solely in the interest of plan participants. Such a fiduciary may determine that a pro-rata allocation of expenses to a fund that a plan is investing in is, for the reasons set out above, not in the interest of plan participants. Similar issues could arise for investment advisers whose funds are "plan assets" for purposes of ERISA.

For the reasons noted above, investment advisers and investors often agree that the better standard is for investment advisers to allocate expenses among multiple clients investing in the same portfolio investment in a manner that is fair and equitable. The Commission fails to acknowledge that even a "pro rata" allocation itself can be a multi-factor determination. Some investment advisers may use various formulations of "pro rata" for different categories of expenses to achieve a result that is fair to clients and ultimately, to investors. For example, certain expenses dedicated to a particular strategy may be allocated pro rata *based on the capital available to that strategy* across the adviser's clients. Overhead expenses, on the other hand, may be allocated pro rata *based on total commitments* or *based on invested capital (i.e. cost)*. Expenses incurred solely as a result of differently situated investors—such as those subject to the European Union's Alternative Investment Fund Managers Directive—may be allocated to those investors or specialized vehicles *based on the investors' commitment amount*. Insurance costs, which are generally incurred at the adviser level and allocated among clients as necessary in connection with portfolio investments, are often allocated pro rata among clients *based on assets under management or the net asset value of portfolios.* In short, even pro rata allocations can be fairly complex determinations, and a pro rata allocation based on an inappropriate factor would

ostensibly comply with the express requirements of the rule but would be neither fair nor equitable.

The Commission has taken none of these complexities into account and should not adopt a rigid, one-size-fits-all prohibition that overrides, and is inconsistent with, an adviser's own determination of how to discharge its fiduciary responsibilities—particularly when the adviser is doing so in accordance with terms agreed in advance with fund investors. At most, the Commission should require that advisers disclose to all private fund investors the basis for their allocation of fees and expenses among private funds.

Additional problems arise in requiring that broken deal expenses from an unconsummated investment be allocated pro rata to all would-be participants. Sponsors often need co-investment capital from one or more large investors to execute a private fund transaction, or to ensure that the fund achieves its optimum exposure to the transaction. Despite market practice to the contrary, the Proposal assumes that the adviser will have sufficient commercial leverage to impose broken deal expenses evenly on all identified co-investors. In fact, broken-deal expenses are often incurred before prospective co-investors have even executed binding agreements, and sponsors will not always have the leverage to force them to share the expense. Even when co-investors have executed a binding agreement, many fund investors are comfortable with the fund bearing broken deal expenses instead of co-investors in light of the entire commercial arrangement. The Proposal thus drives inexorably towards one obvious result: potential co-investors (particularly those that have significant commercial leverage) will wait until a transaction is certain before committing capital to the co-investment. As a result, the Proposal will almost certainly ensure that funds, not co-investors, are responsible for broken deal expenses all of the time.

Ultimately, restricting the allocation of broken deal expenses in the manner proposed would be harmful to funds and impair capital formation and deployment. Co-investors would be incentivized to wait to commit until the investment opportunity is certain, making it harder still for the fund to obtain the commitments it needs to proceed with a transaction. Without the ability to allocate expenses on a non-pro rata basis, funds may be unable to invest in larger transactions and to attract needed co-investment. The Proposal ignores the potential adverse consequences faced by a private fund in these circumstances, including the possibility that the fund will be unable to conclude a profitable investment because the adviser is unable to demonstrate that it has sufficient firm commitments to finalize the investment. For the same reason, an adviser may be unable to fully syndicate an investment post-closing and, because of the lack of other co-investors to whom to allocate portions of the investment, it is possible that the fund will be stuck with concentration in the investment that the adviser does not believe is in the best interests of the fund.

For all the reasons set forth above, the Proposal's pro rata allocation requirement should be struck in full. In addition, any rulemaking by the Commission that includes the concept of "pro rata" should exclude broken deal costs and should recognize that pro rata allocations can be based on any number of factors and that an adviser should always have discretion to determine the basis of any pro rata allocation (*e.g.*, invested capital, number of investing clients, use of particular services, etc.).

C. Prohibition On After-Tax Clawback.

The Commission's proposal to prevent advisers from taking into account actual, potential or hypothetical tax liabilities in determining the amount of any required adviser clawback has not been sufficiently considered, and is extremely problematic for the industry. The Proposal is also a paradigmatic example of why the Commission should not undertake to regulate the economic terms of private fund agreements.

1. The Proposal Inaccurately Describes Standard After-Tax Clawbacks.

As an initial matter, the Commission's description of how an after-tax clawback operates is inconsistent with how most private equity funds structure such provisions. Respectfully, this is a reflection of the ill-considered nature of the proposed clawback limitation as a whole. The Proposal posits an example in which an adviser receives excess carried interest and its clawback obligation to the fund is reduced by the amount of tax on that excess carried interest, with the adviser returning only the after-tax excess amount to the fund.[184] Under this formulation, the clawback would never restore the adviser and investors to their agreed-upon economic sharing arrangement—but the Commission's example is not an accurate portrayal of standard adviser clawback provisions. Standard adviser clawbacks require the adviser to return the *lesser* of (i) the *total* amount of excess carried interest or (ii) the amount of *total* carried interest received by the adviser, *minus* taxes thereon (commonly referred to as the "**net of tax cap**").[185]

The distinction between the Proposal's example and the net of tax cap formulation is important, because the net of tax cap only operates to limit a clawback amount when the amount of excess carried interest distributed to the general partner represents such a significant percentage of the total carried interest received by the general partner that it includes both amounts distributed to the general partner for it to keep and those amounts already paid in taxes.[186] In this more standard formulation, the burden of tax is not shifted to investors, or even shared with investors. Instead, the adviser bears the entire tax burden and returns the full amount of the clawback until the amount becomes so large that it hits the net of tax cap (such that the adviser might retain no gain at all). The cap simply prevents a requirement that the excess amount required to be returned include amounts that were paid in tax, which most of the industry considers an unfair burden.

---

[184] In the example, the adviser receives excess of $10, and its clawback obligation is reduced from $10 to $7 to take into account $3 of tax on the $10 of excess carry.

[185] Applying the standard approach to the Commission's example, if we assume the adviser received total carry of $20 (with $10 representing excess carry as it does in the Commission's example), the clawback amount returned by the adviser would be $10, which is in fact the entire amount of the total excess carry paid, and not the $7 that the Proposal wrongly asserts would be returned. This is because the net of tax cap produces a cap of $14 ($20 of total carry less $6 of taxes thereon, assuming the same 30% tax rate the Commission uses in its example).

[186] For example, if the tax rate were 30%, the over-distribution would need to represent at least 70% of the total carry received before the full excess amount is not returned to investors.

2. Taxes On Carried Interest Are Costs Actually Borne By Investment Professionals.

Separate and apart from the Commission's oversimplification of how after-tax clawbacks typically operate, there is a very good reason that this tax burden would be unfair if adopted as the Commission proposes: taxes on carried interest are costs that are borne in substantial part by the adviser's investment professionals. Carried interest is often distributed among an adviser's investment professionals as part of their overall compensation, and private equity investors have long accepted that individuals providing services to the adviser cannot be asked to go out of pocket for cash that has been paid to the IRS (or another taxing authority). Accordingly, investors have agreed to a net of tax cap clawback as part of a negotiated set of economic terms.[187]

The Commission's suggestion that an adviser escrow or otherwise delay payments of carried interest to its investment team (to ensure it is left with sufficient proceeds to cover a potential clawback obligation) would still require any member of an investment team who is entitled to carried interest to go out of pocket for taxes.[188] U.S. partnership tax rules regarding how taxable income must be allocated do not depend on whether or how proceeds are distributed to the partners. Instead, even if proceeds are retained or escrowed by the adviser, the adviser must still allocate taxable income attributable to the proceeds to the individuals entitled to carried interest, which then obligates the individuals to make a tax payment. For funds that are in a netting position, taxes can be payable by individuals even if no cash is distributable at all. While in theory any prior income allocated to an individual should be offset by losses in a later year where a clawback is called for, the tax rules on the utilization of losses are complicated, and often prevent such an offset from occurring.[189] Thus, contrary to the Commission's suggestion, the investment professionals of the adviser generally will not be able to avoid the tax rule limitations on loss utilization by amending their prior tax returns.

Advisers of smaller and newer funds are likely to be especially adversely impacted by a prohibition on net of tax cap clawbacks: typically, they have fewer resources, and will find it harder to assume the risk of paying back to investors cash that the carried interest recipients no longer have. More established investment advisers often distribute carried interest to principals of a fund's general partner and the adviser's employees, while the adviser establishes reserves on the adviser's balance sheet to account for potential tax clawbacks. However, many smaller or

---

[187] These terms in many cases include a personal guaranty by individual employees.

[188] In addition to the tax problems with this approach discussed below, the delay of carried interest would also mean that employees would need to be paid more on a current basis from management fees. This is thus another of the many requirements in the Proposal that would put pressure on advisers to increase management fees to the detriment of investors.

[189] The recognition that the tax rules on loss utilization are stacked against taxpayers is the primary reason why, in negotiations, most investors in private equity funds do not insist that tax benefits recognized from the payment of a clawback be taken into account in the net after tax cap clawback. Even in those limited situations where tax benefits are taken into account, investors have recognized that taxes and tax benefits need to be determined based on hypothetical assumptions (determined by the advisers and disclosed to their investors) to avoid any invasive oversight of personal financial information of the adviser's employees.

first-time investment advisers do not have the cash resources to allocate a cash reserve or holdback to mitigate any potential clawback to employees or participants in the general partner. A prohibition on net of tax cap clawbacks would therefore function as a rule that promotes the interests of wealthier, established advisers over smaller and newer entrants.

3. Net Of Tax Cap Clawbacks Are Part Of The Overall Economic Arrangements Heavily Negotiated Between Advisers And Investors.

The misunderstanding that underlies the Commission's after-tax clawback proposal, and the serious disruption it would cause, reflects a more fundamental point: the Commission's proper role does not extend to imposing economic terms that advisers and investors have been freely and fairly negotiating for decades.[190]

The Proposal would upend thousands of negotiated arrangements pursuant to which investors compensate their investment advisers, yet the Commission has not identified a single instance in which the excess carried interest to be returned was actually capped by the tax amounts, much less shown the sort of widespread harm that would justify such a regulatory intervention. Simply, the Commission has not identified a problem that needs to be addressed. In fact, very few investors in private funds attempt to eliminate the tax cap on clawbacks.

The private negotiation process works. Advisers and investors have agreed to a range of waterfall and clawback features that vary from fund to fund, with some being more prevalent and others more custom, but all are designed to provide a fund with a composite of fair provisions that have been recognized to protect investors from losses without creating an unacceptable burden on advisers.[191] In short, investors have successfully achieved netted economics with high-quality clawback protection without the Commission overriding their agreements.[192]

---

[190] The post-tax clawback restriction also illustrates the gap between the prohibitions the Commission proposes and the authority it purports to rely on. The Commission claims to "prevent certain activities that could result in fraud or investor harm." Proposal at 16,920. But the Commission ties no fraud to paying clawbacks post-tax, much less such extensive fraud that might in theory warrant such a disruptive measure. And sponsors and investors being paid and sharing costs as they agreed in a negotiated contract is not "investor harm" under any accepted definition.

[191] Examples of these include (*i*) netting gains against realized losses within a particular fund in the waterfall rather than deal-by-deal economics (which were the original structure for many private equity funds); (*ii*) returning unrealized losses for written off, or in some cases severely and permanently impaired, investments in the waterfall; (*iii*) returning allocated expenses including management fee in the waterfall; (*iv*) providing a preferred return to investors before carry is even distributed; (*v*) providing for a clawback in the first place (in some cases, testing the clawback prior to liquidation); (*vi*) permitting the adviser to distribute amounts that it could take as carry to investors and catch up later and (*vii*) providing for firm or even personal guarantees of the clawback.

[192] One negotiated element of the waterfall—by which funds pay management fees within commitments, and return management fees to investors in the waterfall—reflects a negotiated shift in private equity fund economics through which investors have achieved a substantial reduction in the management fee expenses they bear, while also slowing distributions of carry to the adviser.

The rationale the Commission provides for overhauling these carefully negotiated clawback provisions is as follows:

> "We believe that reducing the amount of any adviser clawback by taxes applicable to the adviser puts the adviser's interests ahead of the investors' interests and creates a compensation scheme that is contrary to the public interest and the protection of investors, even where such practices are disclosed."[193]

That is not a sustainable rationale. In isolation, any contract term that favors (or compensates) one party "puts that party's interests ahead" of the other's. An individual contract term cannot be evaluated in isolation, without accounting for reciprocal and offsetting terms. In this case, the net of tax cap clawback represents investors' concession for a *prior concession* by the adviser—the existence of the clawback itself.

The error of the Proposal's clawback requirement is evident, too, in the first question the Commission asks about the requirement: would it "have our intended effect of ensuring that investors receive their full share of profits generated by the fund?"[194] No, it would not, for multiple reasons: (1) if investors have agreed to a net of tax cap clawback, they *are* ultimately getting their "full share of profits"; (2) there is no pre-ordained "full share" that investors are entitled to, rather, this is determined by negotiation between the parties; and (3) parties can respond to the rule with other adjustments to the economic terms of their relationship. The Commission concedes this, stating that advisers are free to "introduce[ ] some new fee, charge, or other contractual provision that would make up for" the impact of its post-tax clawback restriction.[195] Using the Commission's reasoning, one might say this change would "put the adviser's interests ahead of investors," but the Commission knows such changes are permissible, which further illustrates the absurdity of outlawing a single contract term because it arguably favors one of the parties. Since by the Commission's own admission its clawback requirement *would not* have its "intended effect" of giving investors their supposed "full share" of profits, it would be arbitrary, capricious, and grossly inefficient to adopt it in the first place.

Undermining the Commission's rationale even further is the fact—which it admits—that clawbacks are not required *at all*. It so happens that, as practices have evolved, clawbacks are

---

[193] Proposal at 16,921.

[194] *Id.*

[195] Proposal at 16,949. The requirement would likely force advisers to pay their investment professionals more in salary and bonus, to make up for potential tax losses, and would reduce the alignment inherent in the grant of carried interest to investment professionals. This, too, would be passed on to investors in the form of management fees. In addition, individual employees will be unwilling to provide personal guarantees to return amounts paid in taxes, which would result in a decrease in clawback protections that sponsors have historically been able to provide investors.

one device parties have settled upon to balance the economic terms of their relationship. Many similar industries in fact do not provide for clawbacks.[196]

Two more points follow from the fact that the clawback itself is not required. *First*, in attempting to prohibit the net of tax cap on clawbacks, the Commission is acting outside its authority and outside its expertise. And *second*, by trying to outlaw a single contract term, the Commission is tugging at a string without knowing where it leads. This is reflected in some of the questions it poses to commenters, including whether it should "prohibit deal-by-deal waterfall arrangements (commonly referred to as American waterfalls)."[197] Of course the Commission should not do that: it has no authority to do so, the American waterfall is widely accepted and integral to countless contracts.[198] The total carried interest and any potential clawback in the American waterfall is still dependent on the performance of the fund as a whole. The American style waterfall allows for carried interest to be taken at various points of time as investments are realized. The very fact that the Commission poses this question illustrates how the issue it purports to address in isolation—net of tax cap clawbacks—are part of a constellation of choices, concessions, and trade-offs made by advisers and investors to reach a satisfactory deal. As another example of the Commission's improper focus on individual terms, the Commission fails to appreciate that the "2 and 20" percent model to which it refers is not an industry-wide standard.[199] Investors consider the totality of terms, which could include a higher or lower management fee or carried interest.[200] The Commission cannot step in and tinker with contract terms on an isolated basis.

The Commission's proposed prohibition on after-tax clawbacks thus should not be adopted. If the Commission adopts any regulation relating to after-tax clawbacks, it should require only quarterly disclosures to private fund investors of the potential clawback payable and the amount of carried interest distributions that have been reserved against the potential clawback.

---

[196] Hedge funds, for example provide for an annual incentive allocation based on the increase to the hedge fund's NAV. Subsequent decreases to the NAV do not require the adviser to clawback amounts in view of the fact that investors control the timing of their subscriptions and redemptions.

[197] Proposal at 16,924.

[198] While it is commonly supposed that return of all capital, or "European," waterfalls are less likely to result in adviser clawbacks, this is only true because of the net of tax cap on clawbacks. The tax rules on income allocation are not beholden to whether a waterfall is European or American–even in the former case, gain from any investment may be allocated to the advisor in respect of carried interest even as the cash is diverted to the investors as return of capital. For this reason, every European-style waterfall provides for the advisor to receive tax distributions as a priority to the waterfall. A clawback that does not exclude these tax distributions from being returned does not in any way mitigate the risk of a clawback.

[199] Proposal at 16,891.

[200] In addition, investor bargaining power (often exercised by pension plans with a high number of beneficiaries of the character that the Commission seeks to protect) frequently results in discounted management fees and typically "fee free" co-investment, both of which reduce the purported "2 and 20" fee and carried interest.

D. Prohibition On Borrowing From Clients.

The Proposal prohibits an adviser from directly or indirectly borrowing from a private fund, including through the use of fund assets as collateral for its own indebtedness. We appreciate that, under current law and regulation, this type of transaction will be contrary to an adviser's fiduciary duties in some cases. There are, however, certain types of borrowing or extensions of credit to an adviser that should not be subject to the prohibition, provided that appropriate governance and investor protections are present, including, for example, pre-investment disclosure to private fund investors or other appropriate mechanisms for investors to consent. Many private fund governing documents characterize certain amounts paid to the general partner as a loan, rather than a distribution, for tax purposes (for example, advances to the general partner to enable it to pay tax on its accrued carried interest entitlement ahead of receiving related cash distributions, without resulting in incremental taxable income for the general partner upon receipt of the advance).

The rule as drafted could restrict other practices that are beneficial to investors. For example, an adviser may establish parallel funds that participate side by side in investments on a pro rata basis. Because of the size of an adviser's investment in one of these parallel funds, it may be viewed as a proprietary vehicle of the adviser. As such, the Proposal might prohibit these funds from obtaining a capital call credit facility on a joint and several, cross-collateralized basis, which would provide cost and operational benefits to both funds. We believe that the conflicts presented by such transactions can be properly managed through disclosures to an appropriate conflict review board, such as a fund's limited partner advisory committee, and ensuring that these arrangements are entered into on arm's-length terms.

The Commission should clarify that financial institutions that are (or are affiliated with) limited partners in a private fund are not prohibited from lending to the adviser or its personnel in ordinary commercial arrangements under the "indirect" language of the rule in the Proposal. Similarly, the Commission should clarify that minority investors in private fund sponsors should not be prohibited from doing the same.

Because abusive and fraudulent transactions are already prohibited under existing law and regulation, there is no need for this outright prohibition. As noted above, the Commission's concerns could easily be mitigated with disclosure.

E. Preferential Treatment And Side Letters.

The Proposal would prohibit all private fund advisers from engaging in certain practices related to side letters. Side letters are an important tool in the private fund world used by advisers and investors to tailor the terms of an investment to the particular needs and circumstances of each investor. For example, many investors have internal policy requirements or face certain regulatory obligations that differ from or are not addressed by the fund's standard offering documents. A public pension fund, for instance, may wish to receive specific disclosures in specific formats to facilitate its compliance with certain state reporting requirements. Side letters allow the adviser and the pension fund to agree on contractual terms to address the pension fund's specific need.

The Proposal would undermine the ability of all investors to obtain the unique terms that are important to them. *First*, the Proposal would require advisers to disclose—potentially in real time and prior to the fund's next closing—the side letter agreements that they have reached with other investors. *Second*, the Proposal would prohibit advisers from providing particular investors certain preferential terms regarding fund redemptions. And *third*, the Proposal would prohibit advisers from providing particular investors certain preferential terms regarding information about a fund's portfolio holdings. These rules are unnecessary and would do little more than introduce expensive, cumbersome operational challenges that will drive up costs and dissuade advisers from offering side letters at all.

As an initial matter, the Commission has failed to establish a need for the proposed rules. The Commission asserts that side letters "generally grant more favorable rights and privileges to certain preferred investors,"[201] but that is not their only purpose. Rather than providing certain substantive benefits to select investors, side letters address investor-driven policy or regulatory requirements, and thus do not implicate the Commission's stated concern at all. Regardless, to the extent side letters *do* provide substantive, preferential terms to certain investors, the ability to offer those terms benefits the fund as whole. The Commission ignores the fact that private fund advisers owe fiduciary duties to the fund and thus are *already* barred from agreeing to side letter provisions that disadvantage the fund. So while an adviser, for example, may agree to a large prospective investor's request for certain favorable terms, that agreement—which would facilitate a substantial infusion of capital into the fund—would benefit everyone.

The Commission's proposal is not only unnecessary, but overly broad. It appears that the Proposal's requirement with respect to preferential treatment could apply to informal communications (such as e-mails) between an investment adviser and an investor. This could have a drastic chilling effect on adviser-to-investor communications, which would be detrimental to investors. The Commission should therefore limit the application of any restrictions to written contracts and exclude day-to-day communications.

1. Pre-Commitment Disclosure Of Side Letters.

The Commission's pre-commitment disclosure proposal is unnecessary and would upset the industry's well-established, efficient, and investor friendly system for addressing side letters. Under that system, except as otherwise agreed, advisers disclose side letters at the end of the fund's fundraising period, and investors are then often given the ability to elect side letter provisions granted to other investors, which is sometimes limited to investors with the same or lower level of investment. This existing system alleviates concern over the disclosure of side letter terms. The Proposal fails to recognize that most private funds have a series of closings over a period of months, or even on an ongoing basis. As discussed in greater detail below, giving an investor access to side letter terms granted at the first closing would provide no benefit vis-à-vis preferential terms granted at a third closing.

Requiring the disclosure of side letters in advance of a closing would simply disrupt the fundraising process while doing nothing to further the interests of investors. Operationally, the

[201] Proposal at 16,928.

Commission's proposal would be a nightmare, even if limited to side letters with investors in prior closings. In addition, multiple investors often execute agreements on the same closing day. Thus, to disclose to each one of those investors the terms of every side letter of every other investor, advisers would need to provide near real-time disclosure and potentially share *draft* side letters in advance. The Commission's proposal would also likely extend the fundraising process. As investors receive advance disclosure of others' side letters, investors would likely seek to dedicate additional time towards reviewing the disclosed letters and comparing them against their own requests, creating a highly iterative process that would inevitably delay closings, protract negotiations, and raise legal costs substantially. These costs would be borne by investors and the fund as a whole.

The Commission's proposal would also disadvantage investors that participate in earlier closings, as the investors in later closings would have access to an even larger set of disclosed agreements. This dynamic would encourage investors to wait—to try to be the last investor to sign up for a fund—making fundraising even more difficult and time consuming.

In addition to disrupting the fundraising process, the Commission's proposal would degrade the quality of information available to investors. Under the current system, advisers, after closing, organize all of the side letters into a compendium arranged by topic. This compendium is designed to be user-friendly for investors, with redundancies eliminated and side letter provisions categorized by topic. If the Commission were, instead, to require advisers to disclose side letters in advance of each investor's investment, advisers would likely just disclose side letters as they came in and forego the standard post-closing approach. Investors would not be served by this flood of information.

The Commission's proposal would have other negative effects as well. It would generally chill advisers' willingness to provide side letters at all. This would leave many investors (particularly smaller investors) with less likelihood of negotiating provisions that the adviser may have otherwise been willing to accommodate. Confidentiality would suffer, too. For competitive reasons, many investors do not want other investors to know the specific terms they are receiving in side letters. The nearly real-time, continuous disclosure contemplated by the Proposal, however, would make it increasingly easier for investors to ascertain which other investors were receiving which provisions. In the time-crunch created by the Proposal, with advisers racing to disclose letters in advance of closing, advisers would also find it more difficult to appropriately redact side letter provisions before sharing them with other investors, potentially leading to mistaken releases of confidential information.

There is likewise no reason to impose further restrictions on side letters concerning excuse rights—the right to be excused from participating in specific investments. To comply with side letter provisions, advisers will typically seek information from the investor seeking an excuse right about the purpose of the right—for example, whether the excuse right is to comply with a certain law, regulation, or internal policy. The adviser will also seek information about the parameters of the right. Advisers will then summarize this information in the contract or compendium of side letter provisions. As a result, other investors are put on notice as to the reason that a particular investor has received an excuse right by way of side letter provision. Moreover, the fund agreement and pre-investment disclosures clearly explain the impact that an

excuse right would have if ever exercised—for instance, that other investors may have to fund more than their pro rata share of an investment to cover the shortfall and that the excused investor will not benefit from any distributions related to such investment. There is no need for further restrictions.

None of this is necessary. So long as advisers disclose whether they will disclose side-letter provisions after closing, and whether, at that time, investors will be permitted to elect the benefit of other provisions, investors can select funds that will give them the information and opportunities they want. The Commission's proposal is unnecessary and counterproductive.

2. Preferential Redemption.

The Commission's proposal to prohibit advisers from granting certain investors favorable redemption terms should not apply to closed-end funds. Unlike open-end funds, closed-end private funds generally do not provide redemption rights to investors—except in very specific circumstances related to regulatory matters.

Side letters ensure that the investors that are subject to these regulations are still governed by the fund agreement, which typically provides numerous protections designed to limit the impact of any redemptions[202] on remaining investors. Given these protections and the limited scope of redemption opportunities for investors in closed-end funds, there is no reason to impose further restrictions on closed-end funds on these issues. Indeed, restricting these rights would most directly injure those investors facing a regulatory, tax, or commercial issue that requires redemption flexibility, who would be unable to address their issue or would be unable to invest, which would secondarily injure the adviser and have the general effect of deterring capital formation. As long as advisers properly disclose to investors that others may be able to withdraw from the fund, investors are adequately protected.

3. Portfolio Information Rights.

The Proposal to restrict an adviser from providing certain information about the fund's portfolio is also unnecessary, particularly in the context of closed-end funds. As discussed, closed-end funds do not have redemption rights, except in very specific regulatory circumstances. It is thus hard to conceive of any connection between additional information rights and any negative impact on other investors. If the investor with the information right could not use the information to withdraw from the fund, then there is little that investor could do that would detrimentally impact the other investors.

All investors tend to have substantial access to material information in any event. The Commission fails to consider that advisers that are registered investment advisers are already providing regular reporting to all their investors, at least annually, and in most cases on a

[202] In the context of private equity funds, these provisions, to the extent they are granted to investors, may grant investors limited "withdrawal" rights in certain circumstances, although they may take the form of redemptions. Often, the withdrawing investor receives a promissory note which would be paid out of future distributions the investor would have received had it not been required to withdraw.

quarterly basis. These standard fund reports are intended to cover material disclosure points about the fund's portfolio holdings. Many fund agreements also provide every investor with the right to request further information or reports at any time during the life of the fund, so long as the request is reasonably related to the investor's investment in the fund. This access to information about the fund's portfolio holdings further alleviates any concern that customized reporting with certain investors would be to the detriment of other investors.

In addition to being unnecessary, the Commission's proposal would disincentivize advisers from offering the types of tailored reports that certain investors need to invest in a fund. Many investors, for example, have negotiated specific reporting requirements. California-law governed retirement plans, for instance, are legally required to publicly disclose certain fees and expenses. Other investors have other restrictions, and may, for example, be limited to holdings with certain ESG metrics. Providing such reports to *all* investors in a fund would be unduly burdensome and costly for advisers. By restricting whether the adviser can freely provide these reports to some, but not all investors, the Proposal would disincentivize advisers from agreeing to such customized reporting requests at all. This type of limitation has the potential to prevent investors with specific reporting needs from investing in private funds, which would deter capital formation.

The annual notice requirement exacerbates this problem. This requirement fundamentally changes the ongoing compliance burden for advisers. The Proposal seems to encapsulate not only side letter agreements that are negotiated to induce an investor to commit to the fund, but also any additional information or reporting that the adviser gives to an investor during the course of its investment in the fund—even if the disclosure were permitted by the fund agreement. These costs will further erode net investor returns, thus deterring capital formation.

The Commission's proposal also does not appropriately consider alternatives within the existing regulatory framework. For example, under Regulation FD, even a public company may disclose material nonpublic information to a party that is bound by a confidentiality agreement without disclosing the information to existing investors or potential investors.[203] This is yet another example of the Commission proposing to regulate private funds without considering alternatives and existing principles. This aspect of the Proposal, like many others, contradicts the fundamental tenet of securities regulation that sophisticated investors in private issuers require less regulatory safeguarding than retail investors in the public markets.

F. Adviser-Led Secondaries: Fairness Opinion And Disclosure Of Material Business Relationship With Opinion Provider.

Under the Proposal, registered investment advisers will be required to (i) obtain and distribute to investors a fairness opinion from an independent opinion provider prior to closing on an investment in an adviser-led secondaries transaction, and (ii) distribute to investors a

[203] *See, e.g.*, *Regulation FD: Compliance and Disclosures Interpretations*, Securities and Exchange Commission (June 4, 2010), Questions 101.05, 101.06; https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm.

written summary of material business relationships between the adviser and the opinion provider covering the two-year period prior to closing.

Adviser-led secondaries provide private funds and their investors with an alternative means to exit portfolio investments, often allowing investors to realize profits from high-performing investments or to prolong their exposure to select assets by electing to participate in the resulting continuation vehicle. By retaining ownership of a portfolio company through a continuation fund, for example, an adviser can use its familiarity with the company to drive further value and deliver better returns to investors that retain an interest. The Commission acknowledges that adviser-led secondaries can be beneficial for investors.[204]

While fairness opinions can be an important tool in substantiating transaction prices, other means of verifying purchase price information may be more reliable in certain circumstances. Advisers should be encouraged to pursue the most reliable method of determining purchase price and to avoid incurring unnecessary costs ultimately borne by investors. As adviser-led secondaries have increased in popularity, advisers and investors have settled on a number of different means to provide comfort that transaction prices are fairly determined. Often, when market data relating to recent arm's-length transactions is available—for example, as a result of a recent auction process or sale of securities to a third party—that data is considered the best indicator of the value of the securities underlying the transaction. Certain asset classes, such as real-estate and credit-focused funds, obtain third-party valuations of their portfolio assets on a regular basis; in these instances, sufficient data exists to substantiate transaction prices and protect investor interests without the need to obtain a fairness opinion.

Other such examples abound. In certain secondary transactions, for instance, the transaction price is set by selling a minority position in the asset to a third-party investor. This validation from a direct, third-party purchaser is arguably superior to a fairness opinion; the parties settle on an objective market price after the purchaser conducts specific diligence that a fairness opinion provider simply would not perform. Requiring a fairness opinion in these contexts would be duplicative and an unnecessary expense for limited partners. Further, in adviser-led secondaries where the adviser is providing a true "status quo" option for limited partners,[205] the investors' interest remains unchanged, and the conflict of interest concern the Commission cites in the Proposal is plainly not warranted. Here, too, fairness opinions provide no benefit to investors and would have the effect of simply increasing costs for investors.

The Proposal does not recognize, as well, that requirements for price-setting in potential adviser-led secondaries are now routinely negotiated at the formation of a private fund, with the negotiation being largely driven by investors. Requiring a fairness opinion in this context will likely either be in conflict with other valuation approaches already agreed to by investors, or duplicative of already agreed methodologies.

---

[204] Proposal at 16,917-16,918.

[205] In a "status quo" transaction, fund investors have the option to either move their indirect interest in an asset into a separate "continuation vehicle," on the same economic terms that apply to the fund, or to sell their respective interests. Because the economics relating to such roll-over investors remain unchanged, the adviser does not realize a gain on such assets until they are sold by the continuation vehicle.

The Commission's Proposal would ignore these alternative means of obtaining valuations or mitigating potential conflicts in adviser-led secondaries, imposing instead a one-size-fits-all requirement for all adviser-led secondaries. The costs of this, the Commission estimates, will be payments of more than $20 million annually that will ultimately be borne by investors,[206] and a possible decrease in these secondary transactions altogether, "which could decrease liquidity opportunities"—and not merely for "some private fund advisers," as the Commission says, but for investors, too.[207] In fact, the direct costs would be much higher than the Commission estimates: while the Commission states that, based on its "general understanding," the "external cost" of a fairness opinion is $40,000,[208] the true cost is $50,000 to $100,000 for lower and middle market private companies to potentially more than $1 million for sophisticated transactions.[209]

Indirect costs would result, too, including from the time it takes to obtain a fairness opinion and the impact that can have on a private fund's ability to participate in a transaction. Obtaining a fairness opinion can take up to several weeks. Private funds compete with other private funds and strategic buyers for opportunities, and a multiple-weeks delay can easily cause a fund to lose out on a highly sought-after investment.

And yet, while imposing these direct and indirect costs on investors and advisers, the Commission has failed to identify a single instance in which an adviser-led secondary was misvalued to investors' detriment. While the Proposal suggests that the Commission appears to believe that adviser-led secondary transactions present significant risk to investors, a review of Commission enforcement actions dealing with adviser-led secondaries does not support this view.

In these circumstances, the admitted costs of this proposed requirement are not justified by its speculative benefits, and it should be dropped altogether. At a minimum, fairness opinions should not be required when the adviser and its investors mutually agree to rely upon alternative valuation methodologies, whether at the time of the transaction or in the organizational documents of the relevant private fund, such as those identified above. Nor should an opinion be required when an independent third party co-invests in the transaction, thereby providing independent validation of the price without the cost of a fairness opinion.[210] When those conditions exist, the Commission has no rational basis to override the judgment of sophisticated market participants and insist that they obtain a costly independent opinion that they deem unnecessary.

Finally, the requirement that advisers disclose material business relationships with the provider of the fairness opinion will be difficult to comply with (and consistent compliance

---

[206] Proposal at 16954 & 16955.

[207] *Id*. at 16,955.

[208] *Id.* at 16,965 tbl. 3 & n.3.

[209] Kothari Report ¶ 129.

[210] *Id*. at ¶ 128.

across the industry will be a challenge) because it is not clear from the Proposal what constitutes a material business relationship. There are a limited number of valuation firms that oftentimes have multiple engagements for each private equity firm and portfolio. Such disclosure would therefore be of limited additional value to investors and may actually be misleading by suggesting that a conflict of interest exists when it does not.

G. Quarterly Reporting Provisions.

The Proposal would require registered advisers to private funds to provide investors with quarterly statements detailing information about the fund's performance, fees, and expenses. Information must include the "**Fund Table**" (i.e., fund-level information), the "**Portfolio Investment Table**" (i.e., information at the portfolio company level), and performance information, and must be provided to investors within 45 days after each quarter end. The AIC appreciates that reporting is an important tool for investors and does not object to the Commission's focus on reporting in general. However, the AIC's members are extremely concerned with the level of detail prescribed in these reporting requirements and with the 45-day deadline. Lastly, we believe these reporting requirements will be prohibitively expensive for new entrants in the private fund advisory space.

The Commission's Proposal is unnecessary. The Commission bases the disclosure requirements on the purported inability of private investors "to understand and monitor their private funds investments,"[211] and a perceived need to "improve the quality of information provided to fund investors, allowing them to assess and compare their private fund investments better." [212] These statements fail to take account of the current market practice of providing detailed, high-quality disclosure to investors. For example, in support of the proposed reporting requirements, the Commission cites to "Key Findings" in an ILPA Industry Intelligence Report, but the findings in that very ILPA document undercut the asserted need for additional reporting. As ILPA explained, "[c]lear and consistent reporting of fees and expenses is an area that has seen real progress."[213] The Commission also gives insufficient attention to the nature of the adviser-investor relationship. The Commission provides no adequate basis to conclude that investors in private funds need the same or more fee and expense disclosures than retail investors require. Moreover, as discussed above, requiring private funds to report such extensive information is entirely inconsistent with the statutory framework for private funds. There is also no indication in the Proposal that the level of reporting already provided by many fund managers has been assessed as part of the Commission's cost-benefit analysis.

By the Commission's own calculations, these requirements will impose more than $300 million in annual costs[214]—costs that ultimately will be borne by investors. The requirement will

---

[211] *See* Proposal at 16,890.

[212] *Id.*

[213] Key Findings ILPA Industry Intelligence Report: What Is Market In Fund Terms? (2021), *available at* https://ilpa.org/wp-content/uploads/2021/10/Key-Findings-Industry-Intelligence-Report-Fund-Terms.pdf.

[214] *Id.* at 16,963 tbl. 1.

also present serious operational difficulties for all funds and will be particularly challenging, or even impossible, for funds-of-funds and secondary funds.

The Commission seeks to justify the Proposal's standardized, highly detailed reporting requirements by pointing to ILPA's reporting template,[215] but that reliance is misplaced. ILPA's template offers significantly more flexibility to private fund advisers than the proposed rule.[216]

The Commission also seeks to justify aspects of the proposed reporting requirements by citing Ludovic Phalippou's claim that private equity performance is overstated,[217] but as Professor Steve Kaplan has explained, Phallipou's claims are confused or misleading. Phallipou employs inappropriate comparisons, uses the wrong benchmark, selectively looks to the least favorable time period, ignores gains to sellers and the benefit of diversification, contradicts himself, and is fundamentally confused about the nature of competitive markets.[218]

1. The Specific Reporting Requirements Are Impractical And, In Certain Cases, Compliance With The Reporting Requirements Will Be Impossible.

At present, private fund advisers generally provide investors with financial information on a quarterly basis, presented in accordance with generally accepted accounting principles. Ordinarily this includes, at a minimum, a balance sheet, statements of operations, and a statement of the investor's capital account during the first three quarters of the fund's financial year. For funds' fiscal year-end, investors are generally provided annual audited financial statements—prepared, once again, in accordance with generally accepted accounting principles. In addition, since many investors have specific information needs, investors typically negotiate for customized information rights, which may include reports provided in accordance with templates developed by ILPA or based on the investor's own individual reporting template (which would typically include many of ILPA's reporting guidelines). Investors already receive quarterly and annual reports, and documentation when negotiating their initial participation in the fund (including limited partnership agreements, private placement memoranda, and extensive diligence materials) that informs the investor of the types of payments that may be made to

---

[215] *Id.* at 16,893 n.29.

[216] ILPA's reporting template sets out two levels of reporting: Level 1 requires three figures to be reported—total partnership expenses, total offsets to fees and expenses, and total fees with respect to portfolio companies/investments. Level 2 creates sub-categories of reporting within each category in Level 1. ILPA recognizes that "Level 1 summary content may be sufficient for many LPs to monitor their portfolios" and "GPs should have conversations with their LPs regarding the requisite level of reporting." Institutional Limited Partners Association, *Reporting Template Guidance, Version 1.1*, at 7 (originally released in Jan. 2016; revised in Oct. 2016), *available at* https://ilpa.org/wp-content/uploads/2016/10/ILPA-Reporting-Template-Guidance-Version-1.1.pdf.

[217] *See* Proposal at 16,941 nn.281, 283.

[218] *See* Steve Kaplan, What Do We Know About Private Equity Performance? (Aug. 2020); Michael Cembalest, J.P. Morgan Asset & Wealth Management, Food Fight: An Update on Private Equity Performance vs. Public Equity Markets 2 (2021), *available at* https://privatebank.jpmorgan.com/content/dam/jpm-wm-aem/global/cwm/en/insights/eye-on-the-market/private-equity-food-fight-jpmwm.pdf.

related persons. The investor, which is represented by sophisticated counsel in the negotiation, will often obtain the adviser's agreement to alter the types of payments made to related persons, and to report any such payments in a format requested by the investor. The Commission's proposed requirements amount to another way of presenting the same or similar information.

Thus, the proposed requirements would add yet another layer of reporting burdens on advisers. In contrast to the reporting practices developed collaboratively between advisers and investors, the Proposal's quarterly reporting requirements would simply be unworkable for many private fund advisers. Investors *already* negotiate for the tailored reporting that they find most useful and that practice is unlikely to change. The rule would needlessly impose a rigid reporting system on top of the existing framework, with no showing that it is needed.

Various aspects of the Proposal do not reflect the actual structure of private funds. The proposed treatment of liquid and illiquid assets, for example, is not appropriate because its rigidity does not reflect the diversity of industry participants who do not neatly fit within this dichotomy, such as hybrid funds. Moreover, the rule's focus on certain performance metrics may be relevant only for direct funds, not funds-of-funds or secondary funds. In addition, the Proposal seeks to determine the information that advisers would be required to provide based on the exemptions under the Investment Company Act concerning the type of investors in the fund (sections 3(c)(1) or 3(c)(7)), as opposed to the strategies employed by the fund. This makes little sense and would result in unnecessary reporting for a fund that is not a typical hedge fund or private equity fund.

The Proposal would be costly as well. The AIC's members are concerned about the resources that would be required to satisfy the requirements of the Proposal and the unavailability of those resources in the market—particularly from a talent and technology perspective. Talent, for example, is in short supply, and the costs of hiring additional personnel will be significant. Mid-sized and small firms will bear a disproportionate share of the cost.

Specific requirements contain material flaws and amplify this issue. We urge the Commission to consider, for example:

a. *Unlevered Returns.* The requirement to report unlevered returns would require advisers to make various assumptions to calculate hypothetical returns in the absence of a credit facility. These calculations will be expensive and add significant cost to the preparation of an adviser's financial statements. Moreover, the use and implications of leverage will vary with fund strategy and investor characteristics.[219]

[219] In the process of subscribing to any fund, investors negotiate and consent to the fund's use of subscription lines of credit (including limitations on the use of such leverage). Investors appreciate that funds incur leverage for different reasons, often dependent on the fund's strategy. For example, investors will have different expectations regarding the use of leverage in real estate funds as compared to traditional private equity funds. These expectations will necessarily influence investor-driven reporting. A real estate fund customarily enters into a subscription line of credit (i) to fund equity capital for investments between the acquisition of an asset and the fulfillment of investor capital calls relating to such investment; and (ii) to bridge debt financing for

b. *Portfolio Investments.* As a matter of standard practice, advisers fully disclose portfolio reports once a year pursuant to contractual obligations negotiated by investors. Mandating this as a quarterly requirement would require significant additional resources and impose substantial costs.[220] As a result, the transition period for delivering quarterly reports should be extended from one year to two years. This would enable advisers to make the necessary adjustments to their operational and compliance systems. In addition, to reduce costs, the Commission should only mandate reporting for a subset of the fund's covered portfolio investments—for example, those meeting a percentage threshold with respect to the overall net asset value of the fund's portfolio.

c. b. *Disclosures of Payments to the Adviser or its Related Persons.* The obligation to disclose portfolio investment compensation allocated to an investment adviser or any of its related persons is problematic in a number of ways. *First*, the reporting obligations should be limited to require disclosure of "portfolio investment compensation" only when the adviser has discretion or substantial influence to cause the covered portfolio investment to compensate the adviser or its related persons. For purposes of the foregoing definition, an adviser should be deemed not to have "discretion or substantial influence" if (a)(i) the private fund in question, together with other private funds controlled by the adviser, owns less than a majority of the voting securities of the relevant portfolio investment, and (ii) the adviser and its related persons represent less than a majority of the voting members of the board (or equivalent governing body) of such portfolio investment; or (b) the adviser is subject to written policies and procedures requiring it and its related persons to recuse themselves from decisions relating to the compensation of such persons by covered portfolio investments. *Second*, the proposal is problematic in its conceptualization of related persons. A number of investment advisers have related persons that in reality negotiate with the investment adviser or its affiliates at arm's length and would not represent the interests of the adviser in negotiating with a portfolio investment. This is common among investment advisers that are part of complex organizational structures, such as bank-affiliated investment advisers. For example, it is common for a portfolio company to independently contract with an investment

---

underlying investments. When leverage is used as bridge financing for the asset's underlying debt financing (rather than to bridge the fund's equity investment), calculating an "unlevered" return is not meaningful to investors and could be misleading because it is part of the anticipated debt structure. Indeed, opportunistic real estate funds do not typically report unlevered returns, and this practice is consistent with investor expectations. Because investors in these funds have generally not demonstrated any interest in this metric, reporting has thus far not included unlevered returns. Thus, existing opportunistic real-estate funds would find it impracticable, if not impossible, to calculate unlevered historical returns for existing funds. Consistent with our general position that any rule, if adopted, should not apply to existing funds, any requirement to report unlevered returns should not apply to existing real estate funds or any other existing funds, and should be prospective after an appropriate transition period.

[220] Where a portfolio investment represents less than 5% of net asset value of a fund, US GAAP does not require the disclosure of the percentage of ownership of the investment.

adviser's related person for investment banking, brokerage, consulting, or similar services. Because these entities are financially and operationally separate from the investment adviser, their interests are generally not aligned with the investment adviser's interests. We therefore suggest that the definition of "related person" exclude any person that is operationally independent from the investment adviser.[221] *Third*, a transaction involving a *de minimis* amount should not be subject to these reporting requirements. In each of these scenarios, not only would the arrangement not raise the type of conflicts the Commission suggests are problematic, but also disclosure of any such payment would reveal confidential information about the portfolio company to fund investors. This information would have no relevance to a fund investor's investment and obtaining it could be a significant burden for investment advisers.

d. *Administrator Resources.* The Proposal raises a number of concerns regarding third-party administrators. To begin, many private funds rely on external third-party administrators who do not presently provide the level of detail specificity required by the proposed reporting rule.[222] The Proposal would require these third-party administrators to make significant, costly investments in new technology, which will raise prices across the board and diminish investors returns. For example, third-party administrators do not currently maintain in their books and records data such as partnership expenses broken out by category. Investor-level ownership is difficult to track as well, given recurring investor subscriptions and redemptions, which add complexities in tracking relevant data points. Administrators would need to invest significantly in technology to be able to comply with these requirements. Ongoing labor shortages would only compound the burden on administrators in attempting to comply with the Proposal. Given all these challenges, administrators may refrain from providing reporting services, which would further disrupt the administrator industry.

e. *Public Company Obligations.* Under the Proposal, investment advisers that are Advisers Act registrants *and* Exchange Act registrants would be subject to an onerous amount of SEC reporting. These advisers already work closely with investors to balance the needs of their internal demands with investor reporting, and are already subject to numerous quarterly reporting requirements, including periodic and annual filings on Form 10-Q and 10-K, public company disclosures on Form 8-K in connection with earnings reports and other material events, and other quarterly governance requirements. The Commission has provided no cost-benefit analysis to justify the unduly burdensome requirement of taking on yet another quarterly obligation and producing the required portfolio-level

[221] The Commission has previously granted regulatory flexibility with respect to related persons that are operationally independent. *See, e.g.*, the treatment of "operationally independent" related persons under the Custody Rule. 17 C.F.R. §275.206(4)-2 (b)(6).

[222] Funds or their administrators may be unable to produce the required information with respect to legacy funds.

information contemplated by the Proposal—particularly within 45 days of quarter end.

f. *Funds-of-funds.* The above challenges would be exacerbated for funds-of-funds and secondary funds. That is because the definition of "covered portfolio investment" apparently would require funds-of-funds and secondary funds to look through to indirect holdings and determine whether payments have been made to the adviser or a related person, and to aggregate its indirect holdings (based on a question the Commission asked in the Proposal). This would be unduly burdensome. The Commission should make clear that a portfolio investment for a fund-of-funds does not include issuers or entities that the fund invests in indirectly through underlying funds.[223]

g. *Performance Metrics.* Owing to the diversity of private funds, we do not believe a one-size-fits-all requirement for presenting fund performance would be appropriate. For example, finding appropriate public-market-equivalents ("**PMEs**") for private funds that have tailored strategies that are not available in public market indices is often difficult. Requiring fund advisers to use PMEs could result in misleading presentation of performance, particularly because there is no one accepted version of PME, and advisers may be forced to select PMEs that are not comparable to the private fund.

h. Portfolio Company Concerns. The Proposal would also raise concerns among portfolio companies, which will be sensitive to information about their investors and payments to service providers being distributed widely. As noted elsewhere, a single private fund may have hundreds of investors. Many investors are subject to Freedom of Information Act requests and any requirement to disclose substantial portfolio company information may make private funds a less attractive source of capital to certain portfolio companies, thereby competitively disadvantaging private funds.

2. The 45-day Deadline For Advisers To Provide Quarterly Reporting Will Be Difficult, If Not Impossible, To Comply With.

The proposed requirement that quarterly reporting be completed 45 days after quarter-end will be difficult to comply with for many sponsors, particularly with respect to including portfolio company information in the reports, and preparing the report due at year end. Indeed, in part because these reports require swiftly collecting and reporting data on *other* entities—the

[223] If the Commission actually intends for a portfolio investment for a fund-of-funds to include issuers or entities that the fund invests in indirectly through underlying funds, the Commission must say so clearly and incorporate the economic effects into the Commission's analysis. This, the Commission has not done. Accordingly, if the Commission were to attempt to provide that a portfolio investment for a fund-of-funds includes issuers or entities that the fund invests in indirectly through underlying funds, the Commission would need to issue another release providing adequate notice and opportunity for comment on the myriad of issues that would arise under such a proposal. For these reasons, it is our view that the reporting requirements in the Proposal should not apply to funds-of-funds and secondary funds.

portfolio companies—some of the challenges this requirement presents may be beyond the adviser's ability to resolve.

a. *Funds-of-Funds*. The Commission and its staff have acknowledged the practical difficulty that funds-of-funds face when reporting in other contexts.[224] If a fund-of-funds does not receive an underlying fund's quarterly report until the day of the deadline, it will impossible for the fund-of-funds to comply with its reporting deadline. For this reason, funds-of-funds should not be subject to the quarterly reporting requirements in the Proposal.

b. *Aggregation of Portfolio Company Information*: In order to provide quarterly financial reporting, sponsors often have to obtain, aggregate, and analyze information from numerous underlying portfolio companies. Any delay by portfolio companies in providing their quarterly financial data, which may be outside of the fund adviser's control, could therefore cause an adviser to violate the terms of the Proposal.

c. *Conflicts with Other Requirements*: Most advisers are already subject to significant compliance obligations after quarter end. In addition to providing their investors with financial statements and customized reports (including those compliant with the ILPA template), advisers are often subject to other requirements, such as reporting to banks and other lenders, and complying with tax requirements. Adding further reporting requirements within a short time-frame will put a significant strain on an adviser's ability to meet its various obligations–each of which, if not satisfied, can have significant adverse effects on the fund and its investors. For example, delays in complying with borrowing covenants could jeopardize an adviser's existing loans or their ability to borrow on behalf of the fund in the future. In addition, as noted above, advisers affiliated with public companies will be subject to additional demands with respect to quarterly public company reporting.

d. *Overlap with Year-End Audit*: At year-end, the vast majority of registered investment advisers to private funds obtain audited annual fund financial statements as a matter of general practice or, as is most common, to rely on Rule 206(4)-2(b)(4) of the Advisers Act for an exemption from certain requirements of

[224] For example, a fund-of-funds that obtains an annual audit in reliance on Rule 206(4)-2(b)(4) for an exemption from certain requirements of the Custody Rule under the Advisers Act may deliver its audited financial statements to investors within 180 days of fiscal year end, instead of within 120 days as explicitly stated in that rule. The SEC staff defines a fund-of-funds as a pooled investment vehicle that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person of the pool, its general partner, or its adviser. This definition would include many secondary funds. ABA Committee on Private Investment Entities, SEC Staff No-Action Letter (Aug. 10, 2006); *See also Staff Responses to Questions About the Custody Rule*, Question VI.7, *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm.

the Custody Rule. It is unreasonable to expect that, while private fund advisers are undertaking the time-consuming responsibilities associated with an annual audit, they will also be equipped to provide the detailed, time-intensive quarter-end reporting required by the Proposal. As proposed, the quarterly reporting information provided to investors after year-end could be confusing because funds would report pre-audited numbers, which oftentimes differ from the audited amounts. Any deadline for quarterly reporting after the fourth quarter of a fund's fiscal year should be significantly longer than other quarters.

While the AIC considers any new SEC-imposed reporting requirement to be inappropriate and unnecessary, the Commission should at minimum revise the Proposal to provide: (i) 90 days, to issue quarterly reports for a fund's first quarter, second quarter, and third quarter; and (ii) 120 days to issue a quarterly report for the fund's fourth quarter. For the reasons noted above, the quarterly reporting requirements should not apply to funds-of-funds.

3. The Proposal Will Reduce Investor Returns Due To Increased Reporting Costs Without Providing Any Significant Investor Benefit.

Requiring fund advisers to provide investors with the Fund Table, the Portfolio Investment Table, and performance information within 45 days of the end of each quarter will cause funds to incur significant additional costs. *First*, advisers will be required to adapt their reporting function (in some cases, together with the reporting function of their underlying portfolio companies) to be able to prepare the requisite information. In many cases, this will require significant one-time implementation costs. *Second*, advisers (and in some cases, portfolio companies) will incur significant ongoing expenses to prepare and review the required reports each quarter, which will be on top of extensive reports already provided to fund investors. Especially because the information required under the Proposal must be provided to investors within 45 days of each quarter end, a significant strain will be placed on advisers' back-office staff, who—as described below—already face a multitude of other deadlines for providing information to lenders, investors, and other stakeholders, particularly at year-end. Advisers will likely face the choice of increasing their back-office staff or outsourcing certain administrative functions, in each case incurring additional expenses.

The Commission's cost estimates fail to account for any of these added expenses. Importantly, private funds typically bear their own operating expenses, including for financial reporting, and investors already bear third-party costs directly as fund expenses. Whether managed by increased back-office staff or outsourcing to a third party, the additional expenses incurred in implementing and complying with the Proposal will therefore be passed on to the private funds, and ultimately to their investors.

The additional reporting requirements will be particularly burdensome to new and smaller sponsors, which may have smaller operational teams—or no teams at all—to produce the required reports. Over the long term, these smaller sponsors will be required to hire additional employees, disproportionately increasing their financial burden; in the short-term, smaller sponsors face a higher risk of noncompliance, due to the additional burden placed on their smaller operational teams. Ultimately, since smaller sponsors may find themselves less able to

pass increased costs on to investors (and because they will incur disproportionately higher increased costs), some smaller sponsors may be forced out of the market altogether.

Most private fund advisers currently provide limited partners with detailed, fund-level information on a periodic basis. In addition, they provide customized reports as requested by investors.

Institutional investors who participate in private funds adhere to a myriad of reporting requirements informed by regulatory requirements and their own internal policies. Investment advisers provide extensive reporting to these investors, and often have tailored this reporting over time to meet the specific needs of particular investors. Private fund advisers receive and provide numerous ad hoc requests from investors every year to provide additional reporting detail. Private fund advisers provide these reports to sophisticated investors who have the power to demand such reporting. Many sponsors have invested substantial sums of money to build out proprietary reporting templates and systems based entirely on the specific needs of their investors. And, when an investor such as a state pension plan requests specific reporting information, the existing flexibility in reporting allows the adviser to modify its reporting systems to accommodate the investor's needs. In addition, many sponsors have only recently adjusted their reporting systems to provide the standardized reporting agreed with their limited partners or as recommended by ILPA. Many private fund sponsors have adopted the ILPA reporting template or a version close to it as modified by investor needs, and thus any regulatory intervention in relation to a standardized reporting model is unnecessary, given such sponsors' widespread acceptance of the ILPA reporting template.[225] Private fund investors are typically represented by highly specialized advisers, who heavily negotiate the information they receive about their investment, and other financial industry affiliates that process reporting information when received. The Commission fails to acknowledge that, unlike retail investors, private fund investors are uniquely positioned to understand the terms of their individual investments, to compare key information across investments, and to negotiate disclosure tailored to their individual requirements. Moreover, the Commission provides no evidence that disclosures promote competition in any way. For all of these reasons, the Proposal is not necessary, would lead to costly, unnecessary duplication, and offers no significant benefits to investors.

H. Private Fund Audits.

1. Requiring All Private Funds To Obtain Audits Is Unnecessary And Duplicative And Will Lead To Increased Costs To Fund Investors.

The Commission's proposal to require all private equity funds to obtain audits is unnecessary and duplicative. The Commission's stated concern is that a fund adviser might exploit the "subjectivity" inherent in "valuing a private fund's illiquid investments" to overstate the value of the fund's investments and thereby increase the adviser's fee or solicit new

[225] Given this substantial investment in standardization that private equity advisers have already incurred any rule adopted should contain a safe harbor that deems quarterly reports be prepared in accordance with the ILPA template to satisfy the rule's informational requirements, and better tailor the rule's requirements for quarterly reports for other private fund advisers.

investors.[226] Neither concern, however, applies to private equity funds. As the accompanying report of Dr. Kothari explains, "[p]rivate equity funds typically charge management fees based on capital commitments, or sometimes invested capital, neither of which is affected by subjective valuation methods."[227] Moreover, evidence shows that the sophisticated investors who invest in private equity funds base their investment decisions in substantial part on existing investments, which also are not susceptible to subjective valuation methods.[228] Accordingly, the Commission has failed to show a need for applying the proposed auditing rule to private equity funds.

Even if the Commission had shown such a need, the proposed auditing rule is largely duplicative of another rule that is already on the books. Advisers Act Rule 206(4)-2, the so-called "**Custody Rule**," requires advisers who have custody of client funds to maintain those funds with a qualified custodian (*i.e.*, a bank) and to retain an independent public account to verify those funds at least once a year.[229] The Commission staff frequently polices this obligation, which firms generally meet by obtaining a fund audit.[230] The Commission identifies no need for an additional rule.

And indeed the proposed rule would be counterproductive. It would increase the compliance costs borne by investors, thus reducing investor returns.[231] It would reduce the number of suitable auditors available in certain jurisdictions, which would raise audit prices and further degrade investor returns. And it would disproportionately impact those advisers that have operationalized existing private equity funds in reliance on the audit exemption in Rule 206(4)-2. For these and other reasons, the proposed auditing rule should not be adopted.

2. Certain Fund Advisers Should Not Be Required To Obtain Fund Audits.

Even if the Commission were to adopt the proposed audit rule in some form, it should not extend the rule to certain circumstances where it is particularly unwarranted.

First, the Commission should not apply the proposed audit rule to advisers that act as sub-advisers to non-U.S. private equity funds. In these situations, the U.S. sub-adviser typically hires an auditor to conduct a surprise examination of the assets managed by the sub-adviser, as required by the Custody Rule. This auditor must meet the Regulation S-X independence standards. However, the primary (non-U.S.) adviser may elect to have the fund's financial statements audited by an auditor that meets only the AICPA independence standards, not

---

[226] Proposal at 16,912.

[227] Kothari Report ¶ 119.

[228] *See id.* at ¶ 118.

[229] *See* 17 C.F.R. § 275.206(4)-2.

[230] It is rare for fund advisers to choose not to have their funds audited, and advisers that do not choose to undergo an audit do so for specific transactional or jurisdictional reasons or at the request of fund investors themselves (as discussed below) and not as a means to evade regulation.

[231] Kothari Report ¶¶ 122-123.

necessarily all of the Regulation S-X independence standards (as required by the Proposal). This practice is more than sufficient.

Second, the Commission should not apply the proposed audit rule to funds whose investors specifically request that the fund ***not*** obtain an audit, so as to avoid unnecessary costs. These funds are still subject to surprise examinations under the Custody Rule.

Applying the new audit requirement in these two circumstances would harm fund investors in a number of ways. It would unnecessarily increase demand for audits to a level that the market at present cannot support. Costs of audits are thus likely to increase, causing an increase in fund expenses. Furthermore, without any flexibility on auditor independence, advisers would be forced to change auditors and shift away from reliance on the surprise exam, which would also be detrimental to investors. The Commission does not cite any evidence that auditors that currently meet the AICPA standards of independence, but not the standards of independence of Regulation S-X (because, for example, the auditor does certain work for a fund portfolio company), are any less trustworthy or efficient.

Retaining a fund's current auditor, even if it does not meet all the Regulation S-X independence standards, is likely still in the best interest of fund investors. The current auditor is likely better equipped to provide services to the fund, and a change in auditors could add significant costs for fund investors. Given their experience with the relevant adviser, the current auditor is likely more knowledgeable of the applicable fund's operations. A fund's investors typically know and trust its auditor based on its track record, and transitioning to an entirely new auditor could be confusing and concerning to these investors. The current auditor may also have been chosen due to cost sensitivity that would ultimately affect investors. And switching auditors would have significant transaction costs. Provisions of certain contracts for services with auditors, moreover, cannot simply be unilaterally terminated without the risk of legal proceeding, and any such proceeding could result in added cost to investors. Further, the governing documents of a given private equity fund may provide investors with consent or consultation rights regarding any change in the fund's auditor, which may constrain the adviser's ability to comply with this requirement if such consent is not provided. *Finally*, it is possible that, in light of portfolio company relationships, particularly for fund complexes with extensive investment activity and therefore many portfolio companies, there will be few qualified auditors available who satisfy the independence requirements of Regulation S-X. This could force an adviser to select an auditor that it does not believe satisfies its standards for providing services to the fund, thereby potentially harming investors.

3. The Commission Should Modify The Requirements To Obtain A Fund Audit.

At the very least, the Commission should make the following clarifications. *First*, the Commission should clarify that the requirement to deliver financial statements "promptly" provides a minimum of 120 days for delivery.

Second, the Commission should clarify that a registered investment adviser with a principal place of business outside the United States would not be required to comply with the

proposed audit rule with respect to its private equity fund clients organized outside of the United States. This is consistent with the Commission staff's longstanding "registration lite" interpretation.[232]

Third, the Commission should clarify that the fund audit requirement applicable to sub-advisers to private equity funds to take "all reasonable steps" to cause the fund to undergo an audit consistent with the fund audit requirement does not apply to sub-advisers to non-U.S. private equity funds whose primary adviser or general partner (or similar person) is a non-U.S. Adviser, so long as the non-U.S. Adviser causes the fund to undergo an audit performed by an auditor that meets an independence standard.

Fourth, the Commission should clarify that an investment adviser is not required to reconcile a non-U.S. fund's non-GAAP financial statements to GAAP when distributing financial statements to non-U.S. investors. This is again consistent with current Commission staff guidance.[233]

Fifth, the Commission should clarify that a fund's audited financial statements can be consolidated financials, *i.e.*, intermediate structuring vehicles, portfolio company holding companies, and other AIVs, and that the fund does not need separate financials. This, too, is consistent with existing Commission staff guidance.[234]

---

[232] *See* ABA Subcommittee on Private Investment Entities, SEC Staff No-Action Letter (Aug. 10, 2006)

[233] *See Staff Responses to Questions About the Custody Rule*, Question VI.5 *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm.

[234] *See* Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows, IM Guidance Update No. 2014-07 (June, 2014).

AIC Comment Letter to SEC Release No. IA-5955

APPENDIX 1

Report of Professor S.P. Kothari

REPORT OF PROFESSOR S.P. KOTHARI

April 25, 2022

Table of Contents

I. QUALIFICATIONS AS AN EXPERT

1. I specialize in the areas of accounting, economics, and finance as they relate to business analysis, valuation, financial disclosures, and compensation, among other areas. I have senior executive experience in government, academia and industry, with expertise in strategic and policy issues, securities regulation, auditing, and corporate governance. I have been on the faculty of the Massachusetts Institute of Technology ("MIT") Sloan School of Management since 1999. I currently hold the Gordon Y. Billard Professorship of Accounting and Finance. In addition to my faculty duties, I have also held the positions of Deputy Dean, Faculty Director of the MIT-India Program, and Head of the Department of Economics, Finance, and Accounting at MIT. From 2018 to 2019, while at MIT, I co-chaired the Board of Governors of Asia School of Business, Kuala Lumpur.

2. My most recent experience outside academia was at the U.S. Securities and Exchange Commission as the Chief Economist and Director of the Division of Economic and Risk Analysis. In this role, I led 160 economists and data scientists focused on U.S. securities regulation, domestic and international prudential regulation, and data analytics. During 2008 and 2009, I was the global head of equity research for Barclays Global Investors (acquired by BlackRock) and spearheaded the firm's active equity quant research for a $100 billion portfolio and a team of 50 PhDs globally.

II. BACKGROUND

3. I have been asked by the American Investment Council (the "AIC") to assess the potential impacts of the new rules, Release Nos. IA-5955; File No. S7-03-22, (the "Proposal") proposed by The Securities and Exchange Commission (the "Commission"). The AIC's member firms consist of private equity and private credit firms. My opinions regarding the Proposal focus primarily on its potential impact on the private equity segment of the private fund investment universe, although some of my comments may be applicable to other types of private funds such as real estate investment funds or hedge funds. My opinions are preliminary, subject to the limited comment period available to review and assess the Proposal, and subject to

modification based on additional facts, research, or analysis that I may conduct in the future.

4. The private equity sector is a significant contributor to the U.S. economy.[1] As of 2020 the sector included about 4,500 private equity firms and about 16,000 companies backed by private equity capital, employing about 11.7 million people, and about $1.4 trillion of GDP.[2] Private equity firms investing in mature business provide expertise to improve underperformance, infusions of capital, or both. Private equity firms also invest in companies to foster expansion, providing capital that might be unavailable or too costly to obtain from other channels such as public capital or venture capital.

5. Research shows that private equity improves productivity by increasing capital expenditures and reallocating resources to more productive plants.[3] Private equity ownership benefits customers through new product introductions and increased product variety.[4] The financial improvement of private equity owned firms has been traced to improvements in sales and operating margins.[5]

6. The private equity industry (excluding venture capital) is estimated to manage as of 2021 about $2.6 trillion of assets under management, about a fourfold increase from the $0.5 trillion under management in 2005.[6] Annual private equity fundraising reached over $300 billion in 2021, of which about half related to middle market

---

[1] Except as noted, the industry statistics are from EY, "Economic contribution of the US private equity sector in 2020, Prepared for the American Investment Council," May 2021, available at: https://www.investmentcouncil.org/wp-content/uploads/ey-aic-pe-economic-contribution-report-final-05-13-2021.pdf.

[2] Estimates exclude indirect effects of suppliers to the private equity sector and related consumer spending.

[3] Boucly, Quentin, David Sraer, and David Thesmar. "Growth lbos." *Journal of Financial Economics* 102.2 (2011): 432-453. Davis, Steven J., et al. "Private equity, jobs, and productivity." *American Economic Review* 104.12 (2014): 3956-90.

[4] Fracassi, Cesare, Alessandro Previtero, and Albert W. Sheen. "Barbarians at the store? Private equity, products, and consumers." *The Journal of Finance*, Forthcoming (2022).

[5] Acharya, Viral V., et al. "Corporate governance and value creation: Evidence from private equity." *The Review of Financial Studies* 26.2 (2013): 368-402. Guo, Shourun, Edith S. Hotchkiss, and Weihong Song. "Do buyouts (still) create value?." *The Journal of Finance* 66.2 (2011): 479-517.

[6] Based on data from PitchBook. The $2.6 trillion AUM includes about $1.8 trillion in portfolio value and about $0.8 trillion in "dry powder."

fundraising activity.[7] From 2005 to mid-2021 private equity distributed over $2.7 trillion to investors (about $0.4 trillion more than fundraising over the same period).[8]

7. Private equity investors must be accredited investors.[9] Institutions and individuals investing in private equity include governments, endowment plans, sovereign wealth funds, foundations, corporate, public pensions, private pensions, insurers, banks, family offices, high net worth individuals, and others. Private equity target allocations for family offices, governments, endowment plans, sovereign wealth funds, foundations, and corporate investors exceed 10%.[10] Survey data show allocations to private equity increase with investor scale and experience.[11] Similarly, data from U.S. public pensions indicates that allocations to private equity is highest for larger pension funds.[12]

8. Investors benefit from access to private equity funds and investments. Investing in private equity increases average portfolio returns and portfolio Sharpe ratios (a measure of return adjusted for risk).[13] U.S. buyout funds have outperformed public market indices, even after adjusting for leverage and premia associated with small company and value investments.[14] Investors' reported reasons for investing in private

---

[7] Based on data from PitchBook.

[8] Based on data from PitchBook.

[9] Individuals may be accredited investors if they earn income over $200,000 ($300,000 together with spouse), have net worth over $1 million, or hold in good standing Series 7, 65, or 82 license. Institutions may be accredited investors if they are a trust with assets in excess of $5 million, an entity with investments in excess of $5 million, or an entity in which all of the equity owners are accredited investors. SEC, "Accredited Investors – Updated Investor Bulletin," April 14, 2021, available at: https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-3.

[10] 2022 Preqin Global Private Equity Data Pack.

[11] Henry H. McVey, KKR, "The Wisdom of Compounding Capital," *Insights: Global Macro Trends*, vol. 11.1, February 2021. Similarly, survey data from EY finds that allocations to alternative investments increases with net worth. EY, "Where will wealth take clients next? 2021 EY Global Wealth Research Report."

[12] The median public pension plan with assets under $1 billion allocates 0% to private equity, compared to the median plan with assets over $1 billion allocating 8.3% to private equity. *Public Plans Data.* 2001-2020. Center for Retirement Research at Boston College, MissionSquare Research Institute, National Association of State Retirement Administrators, and Government Finance Officers Association.

[13] Gregory Brown, Wendy Hu and Bert-Klemens Kuhn, "Private Investment in Diversified Portfolios," January 2021.

[14] Gregory Brown and Steven N. Kaplan, "Have Private Equity Returns Really Declined?" Keenan Institute Report, April 2019.

equity are mainly for diversification, high risk-adjusted returns, or high absolute returns.[15]

III. SUMMARY

9. As explained in Section IV, private equity is a competitive industry with thousands of advisory firms on one side and sophisticated investors on the other side. Certain characteristics of the private equity industry, which the Commission is concerned about, emerge as a result of negotiations between sophisticated parties, and the literature provides economic reasons for these patterns in the data. For instance, contractual terms, which might look vague on the surface, are a way to handle uncertainties that the general partner ("GP") might face during a long investment horizon as evidenced in the incomplete contracting literature. The Commission is also concerned about the variation in fees and the literature identifies numerous reasons why fees might differ across GPs or limited partners ("LP"s). For instance, fee discounts are typically offered by first time or small advisors to anchor investors, which serves as a signal to attract other investors. Overlooking these findings in the literature, the Proposal might have unintended consequences in an already competitive industry and become detrimental to investors contrary to its aim.

10. As explained in Section V, prohibitions on certain terms of contractual agreements would have implications reflected in other terms and can be more costly for investors due to uncertainties, risk aversion, and deadweight costs. For instance, a prohibition of accelerated monitoring fees or pass-through of compliance costs might result in an increase in other fees, potentially at more than an offsetting amount. A prohibition of limiting liability of advisors would result in higher ex ante fees for insurance premiums or lead to lower returns due to diminished investment risk-taking as advisors seek to avoid potential legal liabilities. A prohibition of non-pro rata fee

[15] 2022 Preqin Global Private Equity Data Pack. The percentage of investors reporting the reason for investing in private equity are: diversification (68%), high risk-adjusted returns (47%), and high absolute returns (50%). Other reasons include low correlation to other asset classes (21%), inflation hedge (6%), reliable income stream (7%) and reduce portfolio volatility (15%).

allocations might make it harder especially for small funds to find co-investors and preclude investors from the benefits of co-investing.

11. As explained in Section VI, the potential benefits of proposed disclosure practices are limited in many situations and might not be worth the cost. Therefore, a blanket rule would decrease returns to investors, impose a disproportionate burden on small firms and become detrimental to competition. A 45-day requirement for disclosure has limited, if any, benefit because private equity investors do not have redemption opportunities and commitments to follow-on funds are unlikely to be significantly affected by delayed reporting of interim results. A mandatory audit requirement has limited benefits for three reasons: (i) unaudited funds are still subject to surprise examinations providing incentives to advisers to avoid over-valuation of assets, (ii) private equity investors are sophisticated enough to see through the manipulation of fair value reporting, and (iii) auditor independence rules may limit the availability of quality auditors for funds not currently audited. For adviser-led secondary transactions, fairness opinion might not be worth the cost if the asset is small or if there is a third party involved in the transaction that provides independent assessment of value. Requiring the disclosure of performance without the effect of subscription facilities is not likely to be beneficial because there is no standard method for such calculations. Finally, fee disclosures before closing of the fund might be detrimental to fund formation by providing incentives to investors to wait for later funding rounds to observe other investors' fees.

12. As summarized above, the proposed rules have negative implications for efficiency and competitiveness, both of which lower investor net returns. Additionally, certain of the proposed rules may curtail the amount of capital invested in private equity (e.g., through lower commitments to co-investments, or diminished investment in private equity due to lower net returns or decreased risk appetite by advisers in their management of fund capital), ultimately leading to diminished capital formation. These cumulative effects are likely to have stronger negative implications for investors than each individual rule proposal on its own. For example, investors' ability to obtain their desired allocation to private equity investment opportunities

would be significantly affected by the combination of decreased attractiveness of co-investing opportunities (e.g., due to requirements to co-investors pay pro rata allocations of deal break expenses) and decreased risk-reward potential of fund investments (e.g., due to higher fees or diminished risk appetite). Likewise, because several rules are likely to disproportionately affect small and first-time advisers, the cumulative effects on such advisers are likely to be significant impediments to fund formation and competition.

13. It is important to note the broader regulatory context in which an increasing share of companies have been going (or kept) private. A study in 2018 found there were a greater number of firms owned by private equity investors than those listed on all U.S. exchanges.[16] This study also found that private equity provided five times more capital than raised by initial public offerings.[17] The shift to private capital is primarily the result of smaller firms being much less likely to go public.[18] One factor cited for the shift toward private capital is the increasing importance of intangible assets, as the value of those assets could be negatively affected by the disclosure requirements imposed on public firms.[19] If private capital becomes more costly or difficult to obtain, as may be the result of the Proposal , this may negatively impact innovation (i.e., capital formation), given the costs associated with public funding as an alternative.[20]

---

[16] Jakob Wilhelmus and William Lee, "Companies Rush to Go Private," Milken Institute, *Access to Capital*, August 2018.

[17] Jakob Wilhelmus and William Lee, "Companies Rush to Go Private," Milken Institute, *Access to Capital*, August 2018.

[18] Craig Doidge, Kathlee M. Kahle, G. Andrew Karolyi, and Rene M. Stulz, "Eclipse of the public corporation or eclipse of public markets?" European Corporate Governance Institute, working paper 547/2018, January 2018.

[19] Craig Doidge, Kathlee M. Kahle, G. Andrew Karolyi, and Rene M. Stulz, "Eclipse of the public corporation or eclipse of public markets?" European Corporate Governance Institute, working paper 547/2018, January 2018.

[20] Craig Doidge, Kathlee M. Kahle, G. Andrew Karolyi, and Rene M. Stulz, "Eclipse of the public corporation or eclipse of public markets?" European Corporate Governance Institute, working paper 547/2018, January 2018.

14. A number of the proposed rules are likely to place disproportionately higher burdens to advisers of small and first-time funds.[21] There are several implications of burdens falling disproportionately on such advisers. First, because competition in the industry is ensured by new entrants, any regulatory burdens that fall disproportionately on first-time advisers will necessarily dampen competition between advisers, with the resulting decrease in lower-cost investment opportunities for investors. Second, because small and first-time funds may need to pass on the cost of the added burden to investors, investors in the aggregate are likely to allocate less capital to such funds due to the decrease in expected net return. Decreased capital allocation to small and first-time funds may decrease capital formation among smaller private firms, who will find capital more costly or difficult to obtain. Third, higher burdens on first-time funds will decrease opportunities to develop investment adviser talent. Data indicate that most women and minority-owned funds are associated with smaller funds (median size $100 million) and first-time funds (48% to 63% of such advisers are associated with first-time funds, and additional 9% to 27% are associated with second funds).[22] Any extra burden on small and first-time funds will therefore impact development opportunities for women and minority-owned funds.

IV. GENERAL OPINIONS

15. Before presenting a detailed analysis of rules in the Proposal, this section provides a general discussion of the private equity industry which is relevant for most of the Proposal and forms the basis as to why the Commission's analysis of each rule is inadequate.

16. The private equity industry is competitive with thousands of advisory firms on the one side and sophisticated investors on the other. The Commission does not argue that there is monopoly power in the industry but claims that the Proposal will enhance

[21] For example, the costs associated with prohibitions of charging establishment costs, tax-adjusting adviser clawbacks, limiting liability and non-pro rata fee allocations are likely to fall disproportionately on small funds and first-time advisers.

[22] Fairview Capital, "Woman and Minority-Owned Private Equity and Venture Capital Funds," *2021 Market Review*.

competition.[23] In an already competitive and growing industry, increased regulations might create incentives unforeseen by regulators and harm competition, contrary to the aim of the regulations.

17. Among other things, the Commission is concerned regarding the vagueness of contracts between LPs" and GPs. Considering the complexities and investment horizon in private equity industry, some vague terms in contracts are expected and necessary, as explained by incomplete contracting theory. Incomplete contracts are endemic to long-term agreements with many uncertainties that are too costly or impossible to write numerous contingencies into contracts. Many incomplete contracts may be difficult to enforce through traditional dispute resolution mechanisms (such as the court system). Reputational concerns are the main mechanism observed in the enforcement of incomplete contracts.

18. The Commission is also concerned about the variation in private equity fees, suggesting that investors with weak negotiation positions pay excessive fees as compared to larger investors with more leverage. The literature provides numerous economic reasons for variation in fees. One important finding in the literature is that variation in fees is often the result of the advisory side lack of negotiation power – that is, investors with leverage (e.g., large capital allocations) can extract better terms from advisers with weak negotiating positions such as advisers to small funds or new entrants to the adviser business. As discussed below, empirical literature suggests that advisory firms without a strong track record offer preferential terms to anchor investors to attract other investors. Although the literature confirms that larger investors are able to extract better terms, it also shows that fee differences are not the result of advisers providing preferential treatment to preferred clients, but, rather, the result of arm's-length negotiations where weaker advisers provide concessions to attract large investors who help in fund startup and signaling GP quality to smaller investors.

[23] The Proposal, page 263.

19. Financial regulations can focus on a single term of a transaction in isolation but a prohibition on a single term can impact other terms of the agreement. Through general equilibrium effects, regulations can have unintended consequences sometimes contrary to the aim of the regulation. As discussed in greater detail below, the Proposal overlooks indirect costs of the Proposal, such as the potential for higher fees or reduced competition, or loss of efficiency as contracts are renegotiated to second-best outcomes constrained by the proposed prohibitions and requirements.

20. Finally, direct costs of regulations such as required employee hours estimated by the Commission are likely substantially underestimated. Furthermore, the costs quantified by the Commission exclude significant indirect costs discussed below, such as decreased risk-taking by advisers with resulting decrease in fund returns, higher fees to compensate advisers for litigation risk or risk of tax-losses from clawbacks, or decreased competition as burdens fall disproportionately on smaller and new advisers. Burdens will fall on all advisers and mid-sized and smaller adviser firms will feel the consequence of these burdens particularly acutely, diminishing competitiveness of the adviser business and discouraging new entry. Investors are likely to experience costs as well, including both direct costs of increased fees (e.g., to pay for advisers' insurance premiums in the absence of simple negligence indemnification) and indirect costs of inferior investment opportunities (e.g., lower risk-taking by advisers, higher costs due to more limited adviser competition, or more limited availability of new advisers).

A. Private Equity Industry: Sophisticated Investors and Competitive Markets

21. The Commission acknowledges that investors in private equity industry are sophisticated but incorrectly assumes that "even sophisticated investors would be unable to protect their interests or make sound investment decision" in the current state of the private equity industry.[24] Increased government intervention to this competitive market will create inefficiencies and is likely to reduce capital formation due to lower returns for investors.

[24] The Proposal, page 9.

22. Sophisticated investors have invested increasing amounts in private equity over the years. The SEC has not cited systemic risk as a justification for the proposed rules, only investor protection. However, growing assets under management and industry fund inflows are indicators that investors in the aggregate do not see a lack of adequate information as an obstacle to making investment decisions under existing industry disclosure practices.[25] Surveys of public pension fund investors reveal increasing allocations of investments to private equity funds. As illustrated in Figure 1 below, the median allocation to private equity among sampled public pension funds has risen from less than 1% in 2001 to about 9% in 2020.[26] Such increasing allocations to private equity are inconsistent with public pension fund investor beliefs that investment in private equity is disadvantageous in terms of expected net returns after all fees, or that the investors lack sufficient disclosures to make such investment decisions. Similarly, private equity fundraising has been significant (over $2.7 trillion from 2007 to 2021) and growing (compound annual growth rate of about 2.8% from 2007 to 2021).[27]

23. Contrary to the Commission's claim, economic literature suggests that sophisticated investors are well equipped to protect their interests. One study finds that the "evidence is most consistent with the view that private equity management contracts reflect efficient bargaining by sophisticated parties. In such an equilibrium, fees reflect agency concerns and the productivity of manager skills, yet agency costs remain nonzero as an unavoidable consequence of the information frictions inherent in any agency relationship."[28] Other research finds that even if some managers inflate their reported returns during times of fundraising of follow-on funds, "those managers are less likely to raise a next fund, suggesting that investors can see through

[25] Data from PitchBook show annual capital contributions to private equity increased every year from 2014 to 2020, and assets under management grew by about 11.7% compound annual rate from 2014 to 2020.

[26] *Public Plans Data.* 2001-2020. Center for Retirement Research at Boston College, MissionSquare Research Institute, National Association of State Retirement Administrators, and Government Finance Officers Association.

[27] Based on data from PitchBook for U.S. PE fundraising activity.

[28] Robinson, David T., and Berk A. Sensoy. "Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance." *The Review of Financial Studies* 26.11 (2013): 2760-2797. This research does not find support for the view that GPs extract rents and have inadequate incentives, resulting in poor returns for LPs.

the manipulation on average."[29] Investors are also able to understand their level of sophistication and opt for lower risk investment strategies where appropriate.[30]

24. As the Commission acknowledges, there are 5,037 registered private advisers with $18 trillion assets under management in the private funds sector. There are numerous private equity advisers that investors can choose from, and competitiveness of the industry is an important factor preventing harm to investor. Competition is evident in the large number of private equity fundraisings by year, averaging about 284 funds each year, over half of which are smaller funds of less than $250 million.[31] Competition is also evident in the number of new entrants to the industry, with between 15% and 33% of fundraising conducted by first-time funds.[32]

25. Prohibitions in an already competitive industry can lead to one of the three outcomes: (i) a prohibited practice or increased adviser cost can be compensated for by raising fees an offsetting amount, an outcome that is likely in an industry where advisers' profits are determined in a competitive environment, (ii) a prohibited practice or increased costs can be compensated for by raising fees more than offsetting amount resulting in losses to investors, an outcome that is likely when the existing practice is efficient and the next-best alternative is more costly to investors (e.g., a prohibition of indemnification can lead to higher management fees to compensate for unforeseeable litigation costs, uncertainty, etc.), and (iii) to the extent that the prohibitions adversely affect incentives in a way unforeseen by the Commission, beneficial investment risk-taking or adviser-industry competition might decrease, resulting in lower net returns to investors.

---

[29] Brown, Gregory W., Oleg R. Gredil, and Steven N. Kaplan. "Do private equity funds manipulate reported returns?" *Journal of Financial Economics* 132.2 (2019): 267-297.

[30] For example, a study of Dutch pension funds found that smaller pension funds are less sophisticated than larger funds, and that less sophisticated funds opt for investment strategies with less risk. Jan de Dreu and Jacob Bikker, "Investor sophistication and risk taking," *Journal of Banking & Finance*, 36:7, July 2012, 2145-2156.

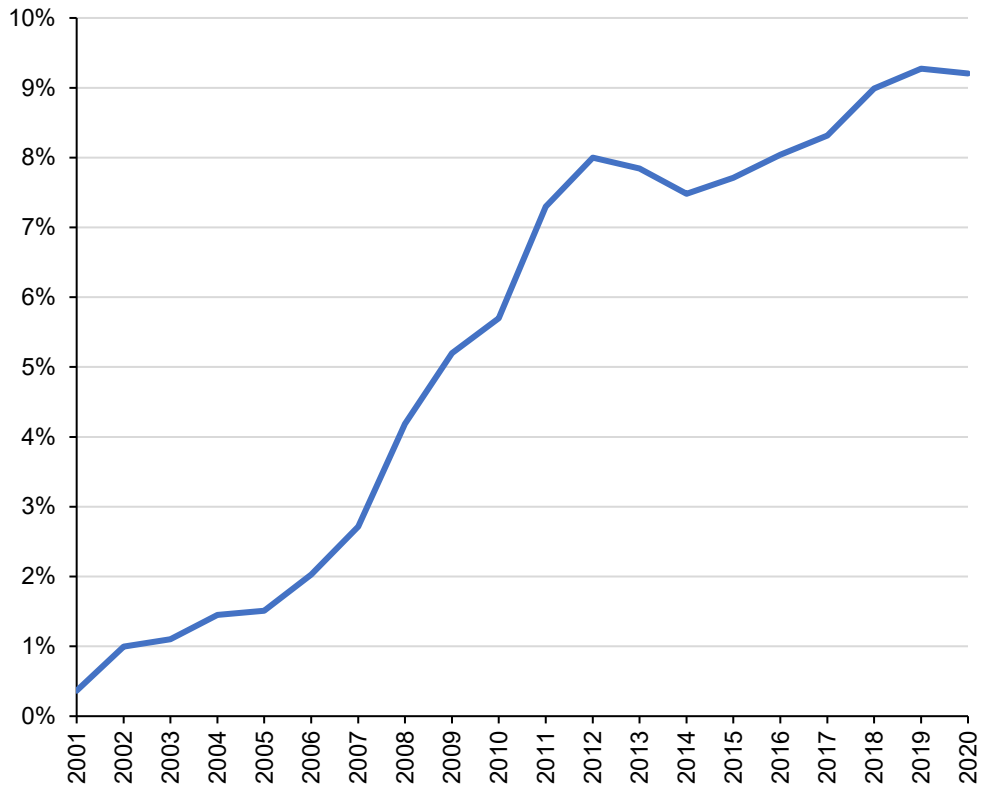
[31] Data from PitchBook for 2007 to 2021. Note that most of the value raised is by larger funds of over $1 billion.

[32] Data from PitchBook for 2007 to 2021. First-time funds tend to be smaller, with a weighted-average of about $133 million of capital raised per fund.

26. Returns to investors are determined by industry dynamics in a competitive market. Regulations might change who pays the cost but they do not determine who bears the burden (tax incidence). Investors have many options for investing their funds, including not only private funds but also public vehicles, direct investment, etc. Competitive capital markets ensure that net rates of return are, on average, commensurate with risk. Any regulation that raises the marginal cost of investing in private funds will lower the net rate of return, and, therefore, likely lead investors on the margin to reallocate capital to other investment choices.

27. Just as the market for capital is competitive, the market for advisory services is also competitive, and has a required rate of return to the advisors to compensate them for the risks they bear. To the extent regulations add costs or increase risk to the manager, it is likely that contracts will adjust other terms to return the advisor's business risk-adjusted profitability to a market clearing equilibrium. Because the investment advisory business is competitive (thousands of advisors), the presumption that advisors earn, on average, a competitive risk-adjusted rate of return is appropriate. In that setting, any regulation that increases the cost to the advisor is likely to lead to higher costs to investors who will ultimately bear that cost burden, leading in turn to a lower risk-adjusted rate of return to the investor.

Figure 1: Median Allocation to Private Equity Across Sample of U.S. Public Pension Funds[33]



B. The Benefits of Incomplete Contracts

28. Several of the proposed rules attempt to deal with perceived gaps in adviser contracts with investors. As discussed further below, these perceived gaps are not necessarily flaws in private fund contracts. Instead, they are designed to provide benefits to the contracting parties from not incurring the cost of negotiating a large number of contingencies in advance. The following examples illustrate this theme across several of the proposed rules:

- The proposed requirement to disclose fund fees that are not presently required to be disclosed pursuant to fund contracts (though such contracts do not prevent voluntary disclosure) is intended to provide additional information to investors;

[33] *Public Plans Data.* 2001-2020. Center for Retirement Research at Boston College, MissionSquare Research Institute, National Association of State Retirement Administrators, and Government Finance Officers Association.

- The proposed prohibition on fee allocation on a non-pro rata basis is intended to deal with the perceived failure of fund agreements to require allocation of broken deal expenses to co-investors;
- The proposed requirement for fairness opinions in adviser-led secondary transactions is intended to deal with the perceived failure of investor contracts to require such opinions in all cases (notwithstanding that investors are not required to participate in such offerings).

The above illustrates areas in which existing contracts may be vague or "incomplete." "An incomplete contract has gaps, missing provisions, and ambiguities and has to be completed (by renegotiation or by the courts) with strictly positive probability in some states of the world."[34] This provides flexibilities to the parties to adapt the agreement to changing circumstances over time rather than specifying blanket rules in advance. The literature on incomplete contracting find that its existence is due to "transaction costs [that] prevent some aspects of the future trade from being contracted ex ante (while still allowing the parties to contract on these aspects ex post)."[35] The vague terms or gaps in incomplete contracts may be beneficial in forcing the parties to avoid litigation if disputes arise.

29. Incomplete contracts serve an important function. Consider a situation in which a fund anticipates that it may need co-investor financing to complete future deals. LPs might prefer that co-investors share in any broken deal expense. However, when the adviser and investors enter into fund agreements, they do not know what co-investment opportunities may arise, nor what terms co-investors might require to participate in such co-investment opportunities (such terms might change with market conditions). It is impossible or too costly to write and enforce a contract contingent on all the possible outcomes of negotiations between advisers and all the potential co-investors. GPs are therefore afforded the flexibility to offer terms to co-investors on a case-by-case basis. Nevertheless, the GP retains an incentive to act in the interest of

[34] Hart, Oliver. 1995. *Firms, Contracts, and Financial Structure*. Oxford: Clarendon Press.

[35] Segal, Ilya. "Complexity and renegotiation: A foundation for incomplete contracts." *The Review of Economic Studies* 66.1 (1999): 57-82.

the fund through carried interest. If a GP abuses the flexibility in some way (for example, by providing some benefit to a preferred client), it imposes a reputational cost for the GP and adversely affects the GP's future fund raisings.[36] This reputational cost discourages GPs from abusing the flexibility. The flexibility provided to GPs is the outcome of negotiations between sophisticated parties and a consequence of the long investment horizon (the typical time horizon for private equity funds is 10 to 12 years) with many complexities and uncertainties, as discussed in the incomplete contracting literature. Prohibition of certain contractual arrangements might discourage co-investors and harm fund LPs if the fund does not have enough capital to invest in large deals, contrary to the aim of the regulation (in addition to the harm to LPs who would make co-investments but for the prohibitions).

30. Performance under incomplete contracts is enforced through other mechanisms such as "reputation, repeated dealings, and norms of reciprocity in order to motivate both beneficial investment *ex ante* and adjustment *ex post*."[37] Repeat dealings are common in the private equity industry. Likewise, parties adopt fair contract terms that anticipate changes – for example, private equity LPAs frequently have "most favored nation" ("MFN") clauses which, in the context of a fundraising that may take place over an extended period with multiple closings, provides that current investors will be treated no worse than future investors.[38]

C. Reasons for Variation in Private Equity Fees

31. The Commission is concerned that "[t]here can be substantial variation in the fees private fund advisers charge for similar services and performances" citing Begenau and Siriwardane.[39] However, the same paper and academic evidence in other literatures confirm that there are economic reasons for different fees or prices charged to investors.

---

[36] While it may be the case that investors in the current fund may be worse off by such abuse of flexibility provided to the GP, that is a risk known to sophisticated investors, and a reason why investors seek advisers with good reputations or, for new advisers without established reputations, may seek fee breaks or other economic benefits.

[37] Scott, Robert E. "The law and economics of incomplete contracts." *Annu. Rev. Law Soc. Sci.* 2 (2006): 279-297. MacLeod, W. Bentley. See also "Reputations, relationships and the enforcement of incomplete contracts." (2006).

[38] MFN clauses may themselves have conditions such that the MFN clause applies only to similarly situated investors (e.g., by size of investment).

[39] The Proposal, page 204.

One important reason is the signaling effect of certain investors such as anchor or seed investors.[40] Advisers, especially those without a strong track record, might offer superior terms to anchor or seed investors to benefit from the signaling effect of such investors and thereby attract additional investors. Furthermore, anchor investors with a large volume of investment enable GPs to focus on investment opportunities and spend less time in search of financing (i.e., a "volume discount" may be appropriate where fixed costs are high, such as with fundraising and organizational costs).

1. Evidence From Other Literatures: Restricted Stocks

32. A well-known price discrimination example in the finance literature is the sale of restricted stocks sold at private placements. Public companies may raise capital through private investment in public equity (PIPE) transactions to accredited investors. Companies can issue registered (freely tradable) or unregistered (restricted) stock in PIPEs. Restricted stock cannot be sold to any interested investor or traded on the public exchange but can be sold to sophisticated investors during a certain holding period, after which the stock becomes registered. Restricted stock is typically sold at a discount compared to the price of the publicly traded stock.

33. Recent literature documents an empirical pattern that the price of publicly traded shares increases after private placement of restricted stocks. There are two not mutually exclusive theories describing the reasons of the discount for restricted stocks and the increase in the price of pre-existing shares: monitoring and certification.

34. Monitoring the management of a company is costly, and it is worthwhile to pay for this cost only to large shareholders. So, as the number of large shareholders (ownership concentration) increases, monitoring gets more efficient. Private placements are associated with an increase in ownership concentration. Investors are compensated for expected monitoring benefits, so shares are sold at a discount. Due

[40] The Commission acknowledges that such investors obtain preferential fees, but offers only limited discussion of the economic reasons justifying their obtaining preferential fees. For example, the Commission argues that advisers "often provide [preferential] terms for strategic reasons that benefit the adviser" but also note that preferential terms can also benefit the fund by, for example, increasing fund assets which may enable the fund to make certain investments. The Proposal, pages 162-163. The Commission, however, offers no systematic review of all the potential benefits to the fund or to other investors that may derive from offering preferential terms.

to this expectation of efficient monitoring, the market reacts positively and price of pre-existing publicly traded shares increase.[41]

35. In general, there is asymmetry of information about the firm value. Therefore, private placement investors perform costly due diligence on the firm before committing to a large purchase. The firm compensates such large investors for the due diligence costs by offering shares at a discount. The transaction signals that the firm must be of high quality because otherwise the large investors would not have bought the shares, leading to a price increase for pre-existing publicly traded shares.[42]

36. Both theories show that firms offer discounts at private placements and benefit from signaling effects of the transaction. Similarly in the private equity industry, anchor investors can be important especially for small firms without much track record. Anchor investors with large investments provide at least two benefits for the private equity firms: (i) a signaling effect certifying the quality of the firm, and (ii) decreasing the time the adviser spends searching for funding and enabling the adviser to focus on investments (i.e., allow the adviser to begin investing to demonstrate quality through current investments rather than only through track record). As will be detailed in the next section, empirical analyses of private equity returns verify the importance of these two benefits.

2. Evidence in the Private Equity Literature

37. The Proposal emphasizes variation in private equity fees[43] and discusses the costs borne by investors related to the operation of the fund. There are numerous legitimate reasons for the variation in private equity fees related to client needs, adviser characteristics, and investor characteristics.[44]

---

[41] Wruck, Karen Hopper. "Equity ownership concentration and firm value: Evidence from private equity financings." *Journal of Financial economics* 23.1 (1989): 3-28.

[42] Hertzel, Michael, and Richard L. Smith. "Market discounts and shareholder gains for placing equity privately." *The Journal of finance* 48.2 (1993): 459-485.

[43] The Proposal, page 204.

[44] If the ex-post realization of the fees are measured as is the case in part of the literature, performance of the fund would be another reason for the variation for funds offering multiple fee structures.

38. Individual fees might vary across funds or within funds for different investors as a result of negotiations to address the needs of an investor. For example, Bain Capital has offered investors funds with two-tiered fee structures, either a 1% management fee with a 30% carry or 2% management fee with a 20% carry.[45] Investors can choose among these options depending on their risk-return preferences. Examining the management fee in isolation will give a skewed view of the costs to investors. Furthermore, when the returns are realized, one investor group might have higher costs compared to the other.[46] Assuming all the other contract terms and investor characteristics are the same, a proper comparison of these two investment options should be based on the expected total amount of fees that will be paid by investors calculated using ex-ante probabilities of each future scenario. This is something that each investor can consider on their own.

39. Similarly, all the terms of a contract between LPs and GPs are a result of negotiations and product differentiation. Because the complexity of such contracts reflects negotiations on multiple dimensions, it is not proper to isolate a specific contractual provision and argue that the single isolated term leads to an unjust treatment to a particular investor group. For example, what appears to be "preferential" terms to one investor may be compensation for benefits that investor brings to the fund and help lower costs or increase returns for other investors. For example, a large investor may help the fund achieve scale economies, open up new investment opportunities unavailable to smaller funds, or as a co-investor may provide expertise that may assist in either transacting or operating a company. An early investor may also provide signaling value to subsequent investors related to the due diligence performed by that early investor.

40. A proper analysis of private equity fees requires collecting all the information about the fees at the onset of the fund and calculate the expected cost and return depending on the probability of each contingency in the contract as is proposed by Saunders et.

---

[45] Markham, Isobel. "Bain keeps two investor class structure for Fund XII." *Private Funds CFO*, 22 June 2017, available at: https://www.privatefundscfo.com/bain-keeps-two-investor-class-structure-for-fund-xii/.

[46] For example, if portfolio performance is strong, total management fee plus carry will be higher for the low management fee / high carry tier structure.

al. for the corporate borrowing literature.[47] Otherwise, even if one analyzes the total fees paid by the investor ex-post, part of the variation in returns will be simply due to realization of certain risks that were taken or not taken by investors depending on their risk appetite, as explained in the Bain example. Note that the paper cited by the Proposal[48] regarding the variation in private equity fees is based on ex-post returns of funds and acknowledges that some of the variation documented in their paper is due to variation in ex-post realization of returns.[49] I am unaware of any empirical studies that properly compare the full set of expected costs on an ex ante basis.[50]

41. The Begenau and Siriwardane 2022 paper cited in the Proposal studies the reasons why some funds offer superior terms to certain investors and also why some investors receive better terms compared to others.

42. They find that 36% of funds have the same return for their investors and 61% have two tiers of return, while the remainder have three or more tiers. They analyze the characteristics of funds with multiple tiers of return and find that advisers with low demand are more likely to offer multiple tiers of return.[51]

43. Overall, they find that advisers without a strong track record of returns are more likely to offer varying fees to investors. They state that "these correlations support the

---

[47] Saunders et al. study the variation in fees and the total cost of borrowing for corporate loans and state that "pricing structure of loan commitments is complex and includes a variety of fees". They "develop a comprehensive total-cost-of-borrowing (TCB) measure that accounts for fees, spreads, and the likelihood that they will have to be paid [and].. suggest that the TCB measure could be used as an alternative […] in future research on the cost of debt.

[48] The Proposal, page 204.

[49] "This does not necessarily imply that these pensions are behaving suboptimally, because some pensions may have traded low management fees for higher carry and simply gotten unlucky ex-post." Begenau, Juliane, 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.).

[50] Such analysis is difficult due to the lack of publicly available information on side-letter agreements, as well as the complexity of measuring expected costs under complex, incomplete contracts where fees or costs may be dependent on a range of uncertain outcomes that vary with market conditions, fund strategy, and other factors.

[51] Begenau, Juliane, 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.). The paper uses four proxies for demand for services of the adviser (i) past performance of the funds raised by the GP, (ii) whether the fund is undersubscribed, (iii) whether it is an early fund of the adviser (first, second or third fund), and (iv) whether the adviser uses a placement agent.

notion that GPs who face low demand are more likely to offer some LPs fee breaks, perhaps as a way to attract more capital commitments (e.g., via signaling effects)."

44. Begenau and Siriwardane 2022 also document the characteristics of investors who consistently get better terms from investors. They find that the best fee tier structure is more likely to be obtained by investors who (i) commit additional capital (relative to fund size), (ii) are large as measured by assets under management (AUM), (iii) reinvest in additional funds with the same GP, (iv) have had past success in manager selection (based on fund performance), (v) were early investors in private equity (i.e., more industry experience), and (vi) have better governance structures (e.g., pension board with more members elected by plan beneficiaries).

45. Overall, there are various reasons to explain the variation in fees and terms of the contracts between advisers and investors. Focusing on the adviser side, empirical evidence suggests that advisers with low bargaining power are more likely to offer fee breaks. Prohibiting negotiations in certain dimensions would hurt especially the small/first time private equity firms and, consequently, harm competition in the industry by raising barriers to entry. Similarly, a closer look at the prohibited rules show that many of them have the potential of disproportionately affecting the small/first time advisers as discussed below.

D. Unintended Consequences of Financial Reforms

46. Financial regulations are often proposed with good intentions of protecting consumers, borrowers, or investors. However, "regulation changes the incentives of agents in ways that might not be envisioned at the time the rules are implemented" [52] and regulators can overlook the general equilibrium effects of the proposed rules. As a result, regulations with the intent of protecting allegedly disadvantaged investors can harm other investors or the very same group of investors aimed to be protected.

47. Unintended consequences of regulations are studied in the aftermath of regulations and provide valuable insights. In their seminal work on regulations, Glaeser and

[52] D'Acunto, Francesco, and Alberto G. Rossi. "Regressive mortgage credit redistribution in the post-crisis era." Working Paper, July 2019.

Shleifer find that "[t]he empirical record of regulation around the world is mediocre at best-and we have argued that in many times and circumstances, doing nothing is the most efficient response to market failures."[53] The literature speaks "to the debate about the costs and benefits of regulating economic activity. Proponents of regulation aim to help vulnerable consumers. But regulators often underestimate the fact that lenders are private organizations competing in a free market, and that they react to the incentives created by regulation based on their own objective function."[54]

48. Regarding unintended consequences of the Dodd-Frank Act, research has shown that regulations about credit rating agencies lead to biased credit ratings[55] which in turn forced certain firms to cut back investment. [56] Another study has found that "[t]he higher costs of originating mortgages in the post-crisis period might have cut middle-class households from the mortgage market altogether, instead of allowing them to access cheaper mortgages."[57] The unintended consequences of regulations also have an impact on the overall economic activity. One study estimates that regulatory restrictions dampened economic growth by about 0.8% per annum since 1980, resulting in a significant cumulative impact on GDP.[58]

49. Given the complex considerations affecting existing fund agreements, it is difficult to foresee unintended consequences of the proposed rules (both prohibitions and requirements). A prohibition intended to protect investors' interests may be met with renegotiation along a different margin. For example, as discussed below, prohibiting

---

[53] Glaeser, Edward L., and Andrei Shleifer. "The rise of the regulatory state." *Journal of economic literature* 41.2 (2003): 401-425.

[54] D'Acunto, Francesco, and Alberto G. Rossi. "Regressive mortgage credit redistribution in the post-crisis era." *Working Paper,* July 2019.

[55] Dimitrov, Valentin, Darius Palia, and Leo Tang. "Impact of the Dodd-Frank act on credit ratings." *Journal of Financial Economics* 115.3 (2015): 505-520.

[56] Sharma, Bina, et al. "Unintended Consequences of the Dodd-Frank Act on Credit Rating Risk and Corporate Finance." *Journal of Financial and Quantitative Analysis*, Forthcoming (2021).

[57] D'Acunto, Francesco, and Alberto G. Rossi. "Regressive mortgage credit redistribution in the post-crisis era." Working Paper, July 2019.

[58] From 1980 to 2012 the study estimates the cumulative effect to reduce 2012 U.S. GDP by about $4 trillion, or about $13,000 per person. Coffey, Bentley, Patrick A. McLaughlin, and Pietro Peretto. "The cumulative cost of regulations." *Review of Economic Dynamics* 38 (2020): 1-21.

tax adjustments to carried interest clawbacks may have offsetting consequences to investors such as higher fees (to compensate managers for any expected tax-loss associated with clawbacks) or delayed portfolio realizations (to avoid triggering carried interest payments that may be subject to clawback). Disclosure requirements could also have unintended consequences if not appropriately limited. For example, disclosures of fund-level fees could affect fundraising negotiations if such disclosures are made prior to final fund closing (investors may have incentives to hold back from early round investment if they can gain from observing fee negotiations through early fund disclosures).

50. The sophistication of the negotiating parties allows the industry to continue to innovate in ways that solve the purported problems the Commission proposes to solve. For example, the prohibition on tax deductions for carried interest clawback may have limited value to investors in light of industry innovations such as more frequent, interim clawback testing or escrow accounts to hold portions of carried interest that are at risk of clawback.[59] By requiring particular disclosures or prohibiting particular practices, the Commission's proposed rules may stifle such innovations and force the industry into sub-optimal outcomes in contracting.

51. "As a general principle, if complex, expensive regulatory requirements are placed on all competitors, the burden will be disproportionately heavier for small competitors and large firms will be relatively advantaged."[60] As I explain in detail elsewhere, private equity firms which offer preferential terms to certain investors are typically the ones with low bargaining power. Also, a closer look at the prohibited practices suggest that small firms will be disproportionately disadvantaged by the proposed regulations.

[59] See, for example, discussion of escrow accounts in David Sussman and Max Viski-Hanka, "Private Equity Funds Clawbacks and Investor Givebacks," Duane Morris LLP, August 2014.

[60] Testimony of Alex J. Pollock American Enterprise Institute July 10, 2012.

E. Flawed Cost Calculations in the Proposal

52. The Commission's cost-benefit analysis is deficient in many ways because it does not take into account the indirect costs and it underestimates the direct costs of the Proposal. The Commission's direct cost analysis relies on several assumptions that lack any supporting empirical basis. In particular, the Commission calculates certain identified costs associated with quarterly account statement preparation and distribution, preparation and procurement of fairness opinions, preparation of a material business relationship summary, preparation of written notice regarding disclosure of preferential treatment, written documentation of annual compliance program, etc.[61] All of these direct cost estimates rely on assumptions regarding the number of hours involved by particular in-house or external parties. In none of these calculations are the assumptions regarding the number of hours required based on empirical evidence such as survey data or wage and hour studies. These hours estimates are unsupported, arbitrary and possibly underestimated.[62]

53. Certain of the costs quantified by the Commission are understated:

- As discussed below, the Commission's estimate of the cost for each fairness opinion (about $44 thousand) is likely too low in light of available information on the cost of fairness opinions (about $50 to $100 thousand, or more depending on deal complexity), the failure of the Commission to consider that many adviser-led secondary transactions involve multiple assets, and the additional costs that fairness opinion providers will charge to provide summaries of material relationships with the adviser and its related persons.

[61] The Proposal, pages 287-304.

[62] For example, the Commission assumes after an initial internal burden of 9 hours, that preparation of financial statements will take only 11 internal hours for four quarterly statements, or less than 3 hours per statement. The Commission doesn't specify how many people are involved, what tasks need to be completed, and whether the Commission's proposed rules would affect the number of hours required. For example, calculating performance absent the effect of subscription line of credit may require internal discussions regarding what methodology and assumptions to apply as well as time performing those calculations, checking results, etc. The Commission also does not consider the time burden on advisers to respond to investor questions or create additional explanatory material to accompany the quarterly statement.

- Certain of the costs of labor rates quantified by the Commission are based on survey data from 2013 and appear to be adjusted only for inflation since then, and not any real income growth for the relevant positions. For example, real average billing rate of law firm partners grew by an annual rate of 4% from 2014 to 2020 or a cumulative 26.7%.[63]

54. Second, as discussed elsewhere in this report, there are numerous indirect costs to investors which may result from the proposed rules. The Commission does not identify these costs, let alone quantify them. These costs are likely to be significant and include such things as higher fees (e.g., to cover advisers' insurance premiums for disallowed litigation indemnifications), lower returns (e.g., due to diminished access to investments requiring co-investing capital), or decreased efficiency (e.g., by requiring advisers and investors to renegotiate contracts to second-best outcomes to adjust for prohibition on tax-adjusted clawbacks). As further described elsewhere in this report, these indirect costs collectively may increase costs to investors, decrease returns, decrease competition in the industry, and diminish capital formation.

F. Impact on Small Advisory Firms

55. As will be explained in the discussions below of specific proposed prohibitions and required disclosure practices, certain additional costs are likely to disproportionately burden small- or first-time advisors. The prohibitions and required practices that are likely to impose disproportionate burdens on small- and first-time advisers include:

- Prohibition of charging establishment costs (which are particularly important for first-time advisers);

- Prohibition on tax-adjusting clawbacks (small and first-time advisers may have less liquidity to meet clawback terms);

[63] Average partner billing rate is $608 per hour in 2014 and $827 per hour in 2020. Growth rates are calculated after adjusting for inflation. Source: 2014 and 2020 Partner Compensation Survey by Major, Lindsey, & Africa. Additional adjustment for real growth would be appropriate to account for 2013 and 2021.

- Prohibition on limiting liability for simple negligence (small and first-time advisers are less able to spread insurance costs across multiple funds);
- Prohibition on non-pro rata fee allocation (the potential decrease in co-investments will be most detrimental to small funds which benefit the most from using co-investments to access larger deals);
- The requirement for adviser-led secondary transactions to have fairness opinions (smaller funds are likely to have transaction sizes that the cost of a fairness opinion become more prohibitive); and
- The requirement for disclosure of fund fees (small and first-time advisers are the most likely to benefit from offering fee discounts to anchor or seed investors who might be more reluctant to commit capital in early fundraising rounds to avoid early disclosure of fee breaks to other investors).

Overall, because the above factors are likely to have a cumulative significant negative impact on small and first-time advisers, the Proposal is likely to be detrimental to competition in the industry by raising barriers to entry on new advisers. Lower competition may result in higher costs / lower net returns to private equity investors, who will, in turn, reduce capital allocations to private equity. Small and first-time advisers are particularly important in capital formation, as they are more likely to serve the capital needs of businesses that are too small to turn to public capital market as an alternative. Finally, as discussed above, because small and first-time advisers provide greater advancement opportunities to women and minority-owned advisers, costs that disproportionately affect small and first-time advisers would disproportionately impact advancement of women and minorities in the private equity adviser industry.

V. PROPOSED PROHIBITED ACTIVITIES

56. The Proposal would prohibit several activities by advisers, including fees for unperformed services (accelerated monitoring fees), charging certain fees and

expenses, reducing clawbacks for taxes, limiting or eliminating liability for adviser misconduct, charging certain non-pro rata fee and expense allocations, adviser borrowing from fund, and certain preferential treatments to investors (preferred redemption rights and preferred information rights). Overall, these prohibitions are likely to raise costs and/or lower returns to investors, decrease competition in the industry, decrease efficiency, and decrease capital formation. The following summarizes likely negative impacts of these prohibitions. The sections below discuss each prohibition in more detail.

- A prohibition on accelerated monitoring fees may result in higher costs (lower efficiency) to investors as advisers opt for alternative fee structures such as full prepayment of portfolio monitoring fees, forfeited flexibility to waive fees on case-by-case basis, or shifting fees to management fees (which may be less tax-advantaged, and may not benefit by contributions from non-fund investors in portfolio companies). Additionally, to the extent accelerated performance fees are still charged under the proposed "reasonable expectation" standard of future services, advisers may seek compensation in advance to cover anticipated litigation or other costs associated with disputes over whether such fees qualify under that standard.

- A prohibition on pass-through of establishment costs is likely to create inefficiencies due to uncertainty on whether an expense is fund related or not. Furthermore, it imposes costs disproportionately on new advisers, which would in turn decrease competition in the industry by discouraging new entry.

- A prohibition on adjusting carried interest clawbacks for taxes may result in additional costs to amend existing contracts, less efficient contracting (as advisers and LPs consider alternative waterfall structures), higher costs to investors (e.g., if advisers seek additional *ex ante* compensation to offset the risk of clawbacks greater than after-tax funds received), decreased efficiency (e.g., if high quality employees are deterred from employment in the industry by clawback risk), and/or lower investor returns (if revised waterfall structures result in delayed realizations and distributions).

- A prohibition on limiting liability under a simple negligence standard would increase costs to investors (to compensate for increases in the advisers' insurance premiums) and decrease the risk-taking appetite of advisers, which would decrease returns to investors and negatively impact capital formation.

- A prohibition on non-pro rata fee allocations would take away the flexibility GPs need to negotiate with co-investors for large investments. This could result in less co-investing activity, which will be detrimental both to funds (which may lose investment opportunities that require co-investing capital) and to investors (many of whom find co-investing beneficial to their investment portfolio due to factors such as greater control over investment selection and lower fees). Smaller funds are particularly at risk for negative impacts of lower co-investing activity as their fund size may preclude more investment opportunities than larger funds. As a result, competition may be negatively impacted by smaller' funds more limited investment opportunities.

- Although the closed-end nature of most private equity funds renders a prohibition on preferred redemption rights largely irrelevant to current funds, such a prohibition may constrain private equity funds from innovating into new structures (such as newly emerging permanent capital vehicles), in which anchor or seed investors may want to negotiate preferred redemption rights in order to induce their participation and thereby provide positive signals to other investors. Providing less room for innovative structures will constrain advisers and investors from finding mutually beneficial, efficient contracts.

- A prohibition on preferential information rights has the potential to decrease efficiency if such a prohibition prevents sharing portfolio investment information with potential co-investors. This would result in decreased co-investment activity (with the resulting potential to decrease capital formation), to the detriment of investors who find such opportunities attractive additions to their portfolios as well as to fund investors who benefit from co-investment. Decreased co-investment activity will disproportionately burden smaller funds and new advisers, leading to decreased competitiveness in the industry.

A. Fees for Unperformed Services

57. The Proposal would prohibit an investment adviser to a private fund from "charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment."[64] The Proposal describes this as "accelerated payments."[65] The Commission argues that because the private fund and its investors "typically" bear the costs of such payments and the adviser typically receives the benefit, such fees create a conflict of interest between the fund and its adviser.[66] The Commission also argues that fees for unperformed services unjustly enriches the adviser at the expense of the private fund and its investors.

58. In order to understand the benefits and costs associated with these fees, it is important to understand what services and value are provided by the adviser. Monitoring fees are charged to compensate for the time and effort spent in working with portfolio companies. Private equity advisers bring their experience and expertise to the management of portfolio companies, thereby facilitating value creation. One study found that "during PE ownership the deal margin (EBITDA/Sales) increases by around 0.4% p.a. above the sector median; and the deal multiple (EBITDA/Enterprise Value) increases by around 1 (or 16%) above the sector median."[67] Their "evidence is consistent with top, mature PE houses creating financial value through operational improvements. Such improvements require skill, and the return to such skill may explain the persistent returns generated by these funds for their investors." They further find "[p]artners with a strong operational background generate significantly higher outperformance in organic deals while partners with a background in finance more successfully follow an M&A driven or inorganic strategy."[68]

---

[64] The Proposal, page 136.

[65] The Proposal, page 136.

[66] The Proposal, page 137.

[67] Acharya, Viral V., et al. "Corporate governance and value creation: Evidence from private equity." *The Review of Financial Studies* 26.2 (2013): 368-402.

[68] Acharya, Viral V., et al. "Corporate governance and value creation: Evidence from private equity." *The Review of Financial Studies* 26.2 (2013): 368-402.

59. It is important to note that portfolio "monitoring" entails more than just oversight of management. Fund advisers may play various roles including management oversight, strategic decision-making, capital management, or transaction support. The value created by active management of the portfolio company will depend on the scale of the investment and investment-specific opportunities for performance improvement or growth. Thus, the value of portfolio company monitoring is not based on strictly a time-based provision of services, but rather the cumulative effect of actions that aim to increase the value of the portfolio company.

60. Given the above background, I find several flaws in the Commission's analysis regarding accelerated monitoring fees. Overall, as described below, the Commission's prohibition on accelerated monitoring fees will lead to less efficiency, as advisers are prohibited the flexibility of fee structures where they may waive fees on case-by-case basis, and advisers may seek additional compensation to offset potential litigation costs if there are any disputes about whether accelerated monitoring fees are allowed in particular instances. The prohibition may also lead to lower investor returns as more advisers may seek up-front payment of portfolio monitoring fees rather than payment over time (thus, increasing the time-value of such fees from the perspective of the portfolio company and its owners).

61. First, the Commission's argument that accelerated fees are for "unperformed" service is unsupported. The Commission wrongly assumes such fees are based on time-based provision of services rather than a fee for the value creation contributed by those services. If monitoring fees are charged based on the deal size, periodic payments instead of a lump sum payment can provide the portfolio company with liquidity management be spreading the costs over time, even though the services and resulting value creation may not correspond to the same time period of payments.

62. An earlier exit from the investment does not change the value of the services received. Indeed, an exit may even provide evidence of the value created by the advisers' actions in the form of realization of a higher enterprise valuation. That is, after a take-private acquisition, the value creation impact of the advisers' services is evident only in changes in the portfolio company's performance (e.g., earnings or

cash flows), but at the time of a realization event such as M&A or IPO, the market value added by the advisers' services can be directly observed in transaction price. Consistent with the approach of determining total monitoring fees based on the deal size, some private equity firms require portfolio companies to prepay monitoring fees at the time of the acquisition.[69] Thus, a prohibition on accelerated monitoring fees may simply shift contract terms to arrange for similar payment in other ways.

63. The Commission argues that as a result of accelerated monitoring fees an "adviser also may have an incentive to cause the fund to exit a portfolio investment earlier than anticipated, which may result in the fund receiving a lesser return on its investment."[70] Given that monitoring fees are not charged based on time-based services, the Commission is wrong to assume there is an inherent conflict of interest in which such accelerated fees present an incentive to the adviser that is detrimental to the fund investors. Just as some firms have turned toward requiring prepayment of monitoring fees (rather than payment over time), a prohibition on accelerated fees might result in even more prepayments rather than any shift toward later exits. Moreover, as the Commission recognizes, where portfolio monitoring fees are offset in whole or in part against management fees there would be no incentive to the adviser to accelerate exits. Finally, the Commission does not consider that sophisticated investors and advisers have negotiated terms that balance competing interests, and that other factors, most notably carried interest, provide offsetting incentives to the manager to maximize investment returns.

64. Second, the proposed prohibition on accelerated monitoring fees is likely to result in higher portfolio monitoring fees in the aggregate. Fund agreements currently provide flexibility to advisers in how to charge for their value-added services. Research has found that advisers frequently waive accelerated monitoring fees, particularly when the exit is through a strategic acquisition rather than an IPO.[71] IPO exits may also be

---

[69] Legath, J. "Transaction and Monitoring Fees: On the Rebound." *Dechert and Preqin* (2011).

[70] The Proposal, page 137.

[71] As many as 72% of leveraged buyouts do not charge accelerated monitoring fees, even though a majority of management services agreements have a provision for such fees. Christian Rauch, and Marc P. Umber. "Private Equity Portfolio Company Fees." *Available at SSRN 2702938* (2016).

only partial exits, requiring continued post-IPO services of the adviser to the portfolio company.[72] However, because advisers cannot foresee what form of exit will take place at a later date, a blanket prohibition on accelerated monitoring fees might result in charging full fees to all portfolio companies regardless of exit channel.

65. Third, the Commission ignores that in many cases monitoring fees (including accelerated monitoring fees) are net beneficial to the fund. Monitoring fees paid by a portfolio company are effectively charged to all of the shareholders of that company, including not only the fund but also co-investors, employee / manager owners, and any other investors. Additionally, most fund agreements provide for offsets against advisers' management fees for fees received from portfolio companies (such as portfolio monitoring or transaction fees). Depending on the degree of such offset and the degree to which non-fund investors bear the burden of the portfolio monitoring fee, the fund can benefit overall (i.e., have management fees reduced by more than the fund's pro rata share of the portfolio company's fees).[73, 74]

66. Overall, a prohibition of accelerated monitoring fees is likely to create inefficiencies in the private equity industry. The existing contractual arrangement provide flexibility to the adviser to waive fees under certain circumstances, and allow spreading the portfolio company's payment for value received over time without regard to the timing of services that provide such value. Prohibition on a particular form of monitoring fee payment may result in higher costs to investors (e.g., if prepayments of such fees exceed the amounts that might have otherwise been charged after taking account of waivers). Moreover, this prohibition may result in deadweight loss of costs for litigation, as parties may dispute whether an adviser has a

[72] Phalippou, Ludovic, Christian Rauch, and Marc P. Umber. "Private Equity Portfolio Company Fees." *Available at SSRN 2702938* (2016).

[73] There may be additional benefit to the fund in that payments from the portfolio company might provide a corporate tax shield that would not be available for fees directly charged to fund investors.

[74] Although the Proposal does not prohibit accelerated monitoring fees in cases where fund advisers *fully* offset management fees, this ignores that even with less than 100% offset the fund and its investors may still benefit from structuring fees in a way that spreads costs to other investors in the portfolio company and which may provide tax benefits.

"reasonable expectation" of providing services to the portfolio company for such fees.[75]

B. Certain Fees and Expenses

67. The Proposal would prohibit an investment adviser "from charging a private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, as well as regulatory and compliance fees and expenses of the adviser or its related persons" even "where such fees and expenses are otherwise disclosed." The Proposal does not change the practice of charging "private funds for regulatory, compliance, and other similar fees and expenses directly related to the activities of the private fund." In cases where it is not clear whether the expense relates to the fund or the adviser, the Proposal states that "an adviser generally should allocate such fees and expenses in a manner that it believes in good faith is fair and equitable and is consistent with its fiduciary duty."

68. The Commission argues that they "do not anticipate this aspect of the proposed prohibited activities rule would cause a dramatic change in practice for most private fund advisers, other than for certain advisers that utilize a pass-through expense model."[76] The Commission acknowledges that "[c]ertain private fund advisers utilize a pass-through expense model where the private fund pays for most, if not all, expenses, including the adviser's expenses, but the adviser does not charge a management, advisory, or similar fee. [The Commission] recognize[s] that this aspect of the proposed rule would likely require advisers that pass on the types of fees and expenses we propose to prohibit to restructure their fee and expense model."[77]

69. The Proposal prohibits charging two types of fees with this rule: (i) investigation costs, and (ii) establishment costs. With respect to the prohibition of charging fund investors government or regulatory agency investigation costs (which may include associated fines or settlements), the prohibition on charging for investigation costs

[75] The Proposal, page 164.

[76] The Proposal, page 141.

[77] The Proposal, page 141.

would likely lead to increased costs for the investors as advisers seek to charge fees up front to cover expected investigation costs, likely at a premium to cover the costs of insuring against uncertain cost of potential investigations. Moreover, because the Commission does not distinguish between investigations related to activities the adviser performed for the benefit of its managed funds (e.g., investigations that might relate to anti-trust allegations stemming from a buyout fund's acquisition activity) or activities alleged to be adverse to those funds (e.g., investigations of adviser wrongdoing in financial statement disclosures to fund investors), a prohibition on charging for such costs may discourage advisers from taking actions that may be beneficial to the fund but invite regulatory scrutiny. Furthermore, to the extent the adviser cannot fully insure against such investigation costs, it might lead to decreasing risk taking behavior by the adviser which would harm investors.

70. Regarding the prohibition of charging investors for establishment costs, the Commission ignores that advisers, like any other business, must earn sufficient fees and carried interest to cover all of their costs (including any overhead associated with being an adviser) as well as provide a fair rate of return to the adviser's owners. Disallowing pass-through of specific overhead expenses does not change the adviser's need to cover all of its costs and still earn a fair rate of return. An adviser prohibited from pass-through of overhead expenses will have two choices: find an alternative way to cover its costs and earn a fair return (e.g., by changing the fee structure from pass-through expenses to fixed management fee), or reduce its costs (e.g., by underinvesting in compliance or other overhead activities).

71. This rule restricts the choice set of advisers and investors and lets them negotiate on a limited number of terms which might not address clients' needs. This may result in less efficiency as advisers and investors may not be able to choose their optimal fee structure. As the Commission acknowledges, this rule is likely to change the fee structure of firms which utilize a pass-through model as these firms will need to charge management fees to cover the regulatory and establishment costs. Changing fee structure is likely to result in higher costs to investors. This is because at the time of fund formation an adviser may not be able to accurately predict expected expenses

and so will charge a higher fee with a premium to compensate for the risk that expenses are higher than anticipated at the time of fund formation.

72. In the cases where funds do not change from a pass-through expense model to a management fee model, the prohibition of charging funds for certain expenses such as the adviser's compliance costs can result in under-investment in those costs. Ultimately, funds and their investors benefit from an adviser's regulatory compliance, even where such compliance activity is not specific to a particular fund. If advisers are unable to charge for such overhead costs associated with managing funds and are unable to compensate in other ways (e.g., by shifting to a management fee model), they will have incentives to under-invest in overhead activities that would benefit the fund. Additionally, in these cases the adviser will face additional compliance costs in determining which expenses are fund-related or not, and potential litigation costs where disputes arise over whether particular expenses could be charged.

73. The Commission also ignores that in a pass-through model the adviser is not earning an excess profit by charging for overhead such as regulatory compliance. If such costs are not recouped, and additional compliance and litigation risk costs are incurred, that adviser will be at a competitive disadvantage in the industry. Thus, industry competition may suffer if some advisers are unable to cover such costs.

74. First time advisers are more likely to charge funds for regulatory and compliance fees. For particularly new advisers with only one fund, if the adviser did not charge the fund for such costs it would need to adjust its fees in other ways, otherwise its expected profitability would decrease. Therefore, this prohibition affects the first-time advisers or advisers of small funds disproportionately. To the extent such advisers are able to compensate through increases in other fees, the net impact on the investor will be at best unchanged. If the adviser is unable to pass along these costs through other fees, competitiveness in the industry will be weakened by the reduced profitability of the advisory business, leading ultimately to less new competitive entrants, and potentially increased profitability of larger, established advisers which can better bear the overhead burden. The resulting decrease in net returns may result in reallocation of capital away from the private equity sector, resulting in decreased

capital formation in portfolio companies whose access to capital may be curtailed or increased in cost.

C. Reducing Adviser Clawbacks for Taxes

75. The Proposal would prohibit an adviser to a private fund 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."[78] The Commission argues that reducing adviser clawbacks for taxes "puts the adviser's interests ahead of the investors' interests and creates a compensation scheme that is contrary to the public interest and the protection of investors, even where such practice is disclosed."[79]

76. Before discussing the limitations of the Commission's proposed rule prohibiting tax adjustments to clawbacks, I note that the Proposal suggests through its example that clawbacks are all paid after adjustment for taxes.[80] Based on my review of a sample fund agreement, and my understanding from counsel, the tax adjustment imposes only a cap on the clawback amount.[81] If the pre-tax clawback amount (i.e., "excess" carried interest) is less than the tax-adjusted *total* amount of carried interest paid, then the clawback would be pre-tax. Using the Commission's example, if excess carried interest were $10 (pre-tax), but the adviser had received $30 (pre-tax) of total carried interest, the clawback would be the pre-tax amount of $10 because that amount is lower than the $21 of after-tax carry received (using the Commision's assumed 30%

---

[78] The Proposal, page 144. The proposal defines "adviser clawback" as "any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements" and defines "performance-based compensation" as allocations, payments, or distributions of capital based on the private fund's (or its portfolio investments') capital gains and/or capital appreciation.

[79] The Proposal, page 146.

[80] "For example, if an adviser received $10 of 'excess' performance-based compensation, the adviser or its owners paid $3 in taxes on such amount, investors often argue that the adviser should be required to return the 'pre-tax' amount ($10), while advisers argue they should only be required to return the 'post-tax' amount ($7)." The Proposal, pages 145-146.

[81] See, also, Chris P. Kallos and Daniel P. Meehan, "Private Equity Carried Interest Clawbacks: Navigating Clawback Mechanisms, Fund Agreement Provisions, Tax Considerations" February 7, 2017 ("Typically, only the clawback cap is tax-effected").

tax rate). Only once the pre-tax excess carried interest increases past $21 would it be limited by the tax adjustment.

77. As discussed below, the fee and carried interest structure is negotiated between sophisticated parties in an efficient contracting environment. Shifting the burden of tax consequences associated with payment and clawback of carried interest would trigger costly renegotiation of existing contracts, and lead to inefficient contracting outcomes as advisers and investors negotiate to a second-best alternative. This would result in net costs to investors.

78. The Proposal for a prohibition of tax-adjusted clawbacks is based on a fundamentally flawed assumption regarding the negotiation positions of advisers and investors. Specifically, the proposal assumes a zero-sum game, where any tax loss (i.e., value captured by the government tax authority) is fixed in size and allocated either to the advisor or LPs. This assumption only holds if one assumes that changing the terms associated with clawbacks would not lead to other changes to the LPA terms. However, because the clawback terms are negotiated in the context of broader fund terms (such as the waterfall structure), a change to the terms of the clawback could have negative consequences to both the adviser and investors. For example, an alternative waterfall structure might be costly to investors in delaying distributions from realizations, while also being costly to the adviser in deferring carried interest distributions. The proposal assumes, therefore, incorrectly, that the adviser has all of the negotiating power and uses that power to impose the tax costs solely on the investor, when, in fact, investors consider that cost in the context of other benefits such as a preferred waterfall structure.

79. Although the Proposal acknowledges that private fund investors "often seek to negotiate [fund] waterfall arrangement, and the timing of performance-based compensation distributions" it also, in direct contradiction to this acknowledgement, argues that "[a]dvisers typically have control over the methodology used to determine the performance-based compensation distributions or allocations, such as any

waterfall arrangement."[82] In fact, advisers do not have sole control over waterfall structure. Rather, it is the result of negotiation. Allowing sophisticated parties to negotiate the waterfall structure (along with terms associated with clawbacks) facilitates the most efficient discovery of terms that balance the interests of advisers and investors. Although within a waterfall structure an adviser may have discretion regarding the timing of investment realization and distributions, investors and advisers negotiate a waterfall structure that provides incentives that each side believes balances between competing interests for earlier or later realizations of investments.[83]

80. The key economic issue for the prohibition on tax deductions from clawbacks is who bears the risk of value lost to a third party, i.e., the tax authorities.[84] The distribution of carried interest triggers taxes in the tax reporting period in which distributions are made. However, the availability of tax refunds for clawback payments is contingent on individual taxpayer situations. For example, the taxpayer might not be able to fully recoup taxes paid if the clawback deduction is taxed at a lower tax rate than the previous tax payment on carried interest received, or may suffer losses if tax refunds are not immediately available due to limited availability of taxable income against which the clawback may be offset. In addition to the direct cost of differences between taxes paid and taxes recouped, clawback payments could increase costs to individual taxpayers associated with tax preparation and filing services.

81. In addition to the costs associated with clawbacks that are not tax adjusted, there are liquidity issues. When carried interest is paid to an adviser's principals and employees, only the after-tax amount is retained. Thus, the individuals who realized carried interest retained only the after-tax amounts and may not have access to funds

[82] The Proposal, page 146.

[83] Research indicates that private equity funds add value to investors by timing their investments. As a result, it is beneficial to a fund to encourage its advisers to exercise discretion in timing of making and exiting investments. See Tim Jenkinson, Stefan Morkoetter and Thomas Wetzer, "Buy low, sell high? Do private equity fund managers have market timing abilities?" *Journal of Banking & Finance*, 2022, 106424.

[84] There is a separate issue of the time value of money associated with the timing difference between the original carried interest payment and any clawbacks. The Proposal does not address this timing issue. It is reasonable to expect sophisticated investors to be aware of this issue in negotiating terms associated with clawbacks.

to pay back pre-tax amount (even assuming the individual maintained sufficient access to liquid funds to repay even that after-tax amount).

82. Depending on individual taxpayer and liquidity situations, the above costs may be significant. As a result, absent offsetting adjustments to the fund's terms with investors, individuals working in the investment advisory industry may demand more up front compensation to offset for the risk of such losses, reduce their willingness to work in the private fund industry, or defer realization of investments that might otherwise be appropriate for realization and distributions to investors. Overall, these alternatives would be detrimental to investors in raising the cost of adviser services or delaying distributions from the fund.

83. Although the Proposal acknowledges that "[a]dvisers and investors often negotiate whether the clawback amount should be reduced by taxes paid, or deemed paid," it fails to consider the economic implications of prohibiting terms that have been negotiated. In an efficient contracting environment, where multiple sophisticated parties negotiate over such terms repeatedly, it is reasonable to expect that shifting the tax costs associated with clawbacks back to the adviser will lead to unintended consequences. Such consequences are likely to include renegotiation of existing contracts to alter the terms of the waterfall structure, and revised negotiation of future fund waterfall structure, to reflect the revised balances of cost and benefits considered by investors and advisers. Because the investment advisory business is competitive, any action that raises costs to all advisers will lead to a shifting of some or all the burden of the cost onto investors. Investors may respond to lower net returns by reallocating capital away from the private equity sector, potentially leading to decreased capital formation as potential portfolio companies may have diminished access to capital or increased cost of capital.

84. Finally, the Proposal does not discuss or measure the extent of purported harm to investors of clawbacks that are adjusted for taxes. Although on its face investors might be harmed by the amount of the tax adjustment, there are two reasons this is not necessarily the case. First, because the clawback terms are negotiated, there is no actual "loss" to investors, but, rather, the realization of a potentially lower return than

otherwise conditional on a particular sequence of events.[85] That is, there is no "loss" because the contract is operating as designed. Sophisticated investors are capable of understanding state-contingent outcomes, as indeed is regularly done with option and warrant contracts, for example. Second, to the extent clawbacks are paid after deduction of the advisers' taxes, the investors' tax paid may be lower (subject to the tax status of the adviser).[86]

D. Limiting or Eliminating Liability for Adviser Misconduct

85. The Proposal "would prohibit an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund."[87] The Proposal argues that "prohibited activities rule would specify the types of contractual provisions that would be invalid" under the Investment Advisors Act.[88]

86. It is important to note that investors and advisers have considered which types of litigation risks to indemnify, and, through negotiation have arrived at mutually-agreed terms. There are inherent risks in investing that investors may want their advisers to take and may choose to indemnify advisers for legal or other costs that might result. For example, a portfolio company might benefit from making acquisitions to achieve better scale economies; however, acquisitions run the risk that the government or

---

[85] That is, the tax adjustment for clawbacks is only deducted if fund returns decrease after early realizations, i.e., a specific sequence of events must occur.

[86] The tax implications to an LP from a tax-adjusted clawback will depend on how the difference between the pre-tax and tax-adjusted clawback is treated for tax purposes. Chris P. Kallos and Daniel P. Meehan, "Private Equity Carried Interest Clawbacks: Navigating Clawback Mechanisms, Fund Agreement Provisions, Tax Considerations" February 7, 2017.

[87] The Proposal, page 150.

[88] The Proposal, page 151. Retail investors are subject to a gross negligence standard. Rule 80a-17(i) of the Investment Company Act of 1940 states, "no contract or agreement under which any person undertakes to act as investment adviser of, or principal underwriter for, a registered investment company shall contain any provision which protects or purports to protect such person against any liability to such company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract or agreement." Private equity investors are more sophisticated than retail investors and are better able to negotiate terms with advisers than retail investors. As a result, if the prosed rule to prohibit indemnification of simple negligence were adopted, private equity investors would obtain greater protections than less sophisticated retail investors enjoy.

other parties challenge the transactions on antitrust grounds. Indemnifying advisers against such costs would make them more likely to pursue acquisition-driven growth for portfolio investments, to the ultimate benefit of fund investors. With that context, it is notable that the Commission's proposed rule would prohibit indemnification of simple negligence, which I understand from counsel may result in excessive litigation given the amount of opportunistic investment on behalf of managed funds necessary to generate compelling returns that require a higher degree of risk than might be present in investments with lower returns.

87. This rule is likely to result in significant costs to the industry in either or both of two ways: increased fees to pay for insurance premia, or decreased risk appetite by investment managers seeking to avoid negative investment outcomes that might lead to lawsuits under a simple negligence standard. Higher costs to cover insurance premia will lower investors' returns, and, in turn, may cause marginal investors to reallocate away from private equity (with the resulting effects on capital formation by portfolio firms relying on private equity capital). To the extent the litigation risks associated with a simple negligence standard are not expected to be fully covered by insurance, advisers will decrease their exposure to litigation risks by taking less investment risks. A decreased risk appetite may also negatively affect investor allocations to the industry, as private equity's higher fee and carried interest structure requires higher expected returns compared to other forms of investment. If advisers were to lower their risk appetite, the risk-reward tradeoff to investors would worsen. Capital formation for portfolio firms that have higher expected returns is likely to suffer as a result of decreased investor allocations to private equity. This could have significant economic efficiency impacts, given the reliance of many small and mid-sized firms on private equity capital to finance and manage turnarounds (avoiding the costs associated with bankruptcy and enhancing real economic productivity) and to fund capital investment for growth (providing for growth in jobs and income to related entities such as suppliers).

88. Research findings reinforce the notion that concerns about litigation can have a significant negative impact on investor returns or capital formation. Regarding initial

public offerings, Hanley and Hoberg find that "[g]iven the inherent uncertainty of an IPO, and the potential reputational losses associated with litigation, issuers and underwriters concerned about lawsuits can attempt to hedge litigation risk by underpricing."[89] Similarly, Arena and Julio study the impact of securities class action litigation on corporate liquidity and find that "firms forgo capital expenditures to save cash in response to increases in litigation risk exposure."[90] In these examples, higher fees (e.g., IPO underpricing) or cash buffers serve to fund insurance against uncertain future litigation costs. In the absence of any ability to obtain insurance at reasonable cost, the party facing litigation risk will likely cut back on risk-taking activities.

89. Economic theory also explains that when agents face significant legal risks and are unable to be indemnified or insured at reasonable costs for such risks, they will curtail their risk-taking behavior that might otherwise be beneficial. For example, corporate managers are typically indemnified from legal risks associated with their business decisions because shareholders and insurers are more efficient risk-bearers through diversification.[91] Absent indemnification or insurance, managers as shareholders' agents would take fewer risks than might otherwise benefit shareholders.[92] Indemnification of legal risks associated with actions taken in good faith is an efficient outcome, as it assigns risks to the party best able to bear that risk (diversified investors or insurers) and supports appropriate risk-taking behavior.

90. Private equity funds are focused on higher expected returns.[93] A foreseeable consequence of advisers not being indemnified for simple negligence claims is a reduced risk appetite in the industry, as negative outcomes from risk-taking would

---

[89] Hanley, Kathleen Weiss, and Gerard Hoberg. "Litigation risk, strategic disclosure and the underpricing of initial public offerings." *Journal of Financial Economics* 103.2 (2012): 235-254.

[90] Arena, Matteo, and Brandon Julio. "The effects of securities class action litigation on corporate liquidity and investment policy." *Journal of Financial and Quantitative Analysis* 50.1-2 (2015): 251-275.

[91] Reinier H. Kraakman, "Corporate Liability Strategies and the Costs of Legal Controls," *The Yale Law Journal*, vol. 93, 194, 857-898.

[92] Reinier H. Kraakman, "Corporate Liability Strategies and the Costs of Legal Controls," *The Yale Law Journal*, vol. 93, 194, 857-898.

[93] "[P]rivate equity investments are regarded as considerably more risky and more illiquid than other assets… Available data indicate that returns to private equity have at times far exceeded returns in the public market." Stephen D. Prowse, "The Economics of the Private Equity Market," Federal Reserve Bank of Dallas, *Economic Review*, Third Quarter 1998, 21-34.

risk investor claims of negligence against the adviser. Given the relationship between risk and return, a decreased risk appetite would result in lower net returns to investors, which, in turn, may lead investors to reallocate capital away from the private equity sector. The risk appetite of the private equity sector is essential to capital formation, as such risk appetite enables potential portfolio companies to access capital markets (or access them at lower cost than otherwise).

91. Any decrease in private equity firms' risk appetite would also decrease efficiency, as investors have preferences of an optimal amount of risk-taking. Given the sophistication of the parties, current contractual arrangements provide incentives for private equity advisers to set an optimal level of risk appetite. Any deviation from that would decrease the efficiency of private equity funds to provide value to investors. Moreover, both advisers and investors are better off if they are allowed to freely negotiate over the optimal level of risk-taking, as well as the compensation and incentive system that best supports that risk-taking. Investors who prefer different levels of risk-adjusted returns can choose to invest in different types of funds or choose not to invest in private equity at all.

E. Certain Non-Pro Rata Fee and Expense Allocations

92. The Proposal would prohibit "an adviser from directly or indirectly 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."[94]

93. It is my understanding that the primary instance where this rule would apply is in the allocation of broken deal expense between a fund and any co-investors. Although co-investors may sometimes pay their pro-rata share of broken deal expenses, they may negotiate terms that preclude being charged for such expenses.

94. The Proposal does not consider several benefits of co-investors to the fund. First, the potential for co-investing opportunities may help attract large investors to the fund,

[94] The Proposal, page 152.

which may benefit other investors in the fund through signaling the quality of the manager, or providing scale to the fund's ability to make investments. Second, co-investors may bring expertise to specific investment opportunities such as industry or geographic expertise. Third, the availability of co-investing capital can reassure the selling shareholders of target investment opportunity (e.g., by showing a commitment of funds to close a transaction). Fourth, co-investing can allow a fund to participate in deals that might otherwise be precluded due to limitations imposed by the fund's size or its concentration limits.

95. By requiring a pro rata allocation of broken deal expenses to co-investors, the Proposal would raise such costs to the co-investors while decreasing the costs to others (i.e., transfers wealth in a way that does not conform to current agreements, negotiations and practice). However, such a transfer of costs from fund investors to co-investors would only take place if co-investment activity remained unaffected by this rule. Co-investors are likely to seek to negotiate different terms of their participation in portfolio investment transactions if they are to be allocated broken-deal expenses in situations where they otherwise would not pay such expenses. For example, co-investors might not make any firm commitment to a transaction prior to closing in order to avoid such expenses. This would weaken the fund's ability to close deals, and, as a result, be detrimental to the fund and its investors. Moreover, if co-investors are unable to fully compensate for the risk of such expenses through altered deal terms, co-investment activity may decrease, resulting in less capital available for investments. This would be detrimental to fund investors who would lose out on deals that might otherwise be pursued with co-investment capital, and may decrease capital formation in potential portfolio companies who would face diminished or more costly access to capital.

96. The Proposal also does not consider the negotiating positions and incentives associated with fee allocations and carried interest. Because advisers realize either lower levels or no carried interest from co-investing, it would be in an adviser's interest to charge fees to the co-investor and reduce fees to the fund. Thus, an adviser's interests in such allocations are aligned with those of the fund. The fact that

such allocations are not made is evidence that it is, on balance, in the fund and the adviser's interest to agree that co-investor not pay broken deal expenses, in order to obtain the benefits associated with co-investing noted above.

97. There are several benefits of co-investing opportunities to an investor, including (i) providing the option to allocate more capital to quality GPs (i.e., allocating more capital to investments managed by a particular GP beyond previous commitments to that GP's fund), (ii) construction of a high-return portfolio by selecting the best opportunities (and leveraging the investor's experience), (iii) allowing the investor to "piggy-back" off the due diligence and investment selection efforts of fund managers, and (iv) obtaining deal flow providing lower fee and carry basis investment opportunities, and (v) providing greater control over investment decisions than under an LP agreement.[95] Funds also benefit from co-investment, through access to capital that facilitates investment opportunities that might otherwise be constrained by fund size and/or concentration limits, by access co-investor expertise, and by greater ability to complete deals with committed capital available.[96] Research finds that deals with co-investing perform as good and often better than deals without co-investing.[97] Overall, then, if the requirement of pro rata expense allocations causes co-investing opportunities to be less attractive, investors will suffer, including both investors participating as co-investors as well as investors in funds offering co-investing opportunities.

98. The Proposal would be more burdensome to smaller funds and new advisers, which are more likely to benefit in deal flow and deal negotiations by obtaining commitments from co-investors. As a result, pro rata allocations of expenses,

---

[95] See, for example, Andrew Beaton and David Smith, "Co-investment: today's economic imperative in private equity asset allocation," The Portfolio Management Atlas, May 2011; and Joseph A McCahery and Erik P.M. Vermeulen, "Recasting Private Equity Funds after the Financial Crisis: The End of 'Two and Twenty' and the Emergence of Co-Investment and Separate Account Arrangements," European Corporate Governance Institute, Working Paper, November 2013.

[96] Reiner Braun, Tim Jenkinson and Christoph Schemmerl, "Adverse selection and the performance of private equity co-investments," *Journal of Financial Economics*, 136:1, 2020, 44-62.

[97] Reiner Braun, Tim Jenkinson and Christoph Schemmerl, "Adverse selection and the performance of private equity co-investments," *Journal of Financial Economics*, 136:1, 2020, 44-62.

particularly as applied to co-investors' allocation of broken deal expenses, will raise barriers to entry for new advisers (decreasing competitiveness of the financial adviser business to the detriment of fund investors).

99. Additionally, because this rule may limit the availability of co-investment capital for smaller funds, the private equity industry in the aggregate might provide less capital to small and mid-sized portfolio investment targets which are too small for the larger funds to target. Thus, availability and cost of capital for private, small and mid-sized companies could increase, resulting in reduction in capital formation.

F. Preferential Redemption Rights

100. The Proposal would prohibit advisers from providing preferential terms to certain investors regarding redemption.[98] It is my understanding that this prohibition primarily affects open-end private funds such as hedge funds which offer periodic redemptions. Because I have been asked to address the Proposal on behalf of private equity and private credit funds which are typically closed-end funds that typically do not offer early redemption, I limit my comments regarding this proposed restriction.

101. As a general matter, the terms associated with redemption rights are an important component of the risk-reward considerations for investors. Any prohibition on negotiated redemption rights will increase the risk of the investment, and could reduce the supply of capital invested, particularly by seed or strategic investors which may have more significant and/or concentrated risk exposures. The loss or reduction of capital from such investors is likely to be detrimental rather than beneficial to other investors. Seed investors lower the barriers to entry for new advisers, increasing the competitiveness of the advisory business. Large, early round investors provide due diligence signaling value to other investors, as well as scale capital to begin investments prior to the close of fundraising (such early investments also reduce uncertainty to later round investors by demonstrating an actual investment rather than relying solely on historical track records).

[98] The Proposal, page 164.

102. Although any prohibition on preferential redemption rights is primarily not an issue for the typically closed-end private equity industry, such a prohibition may raise the cost of innovations of future fund structures. For example, permanent capital vehicles ("PCVs") might offer investors potential for lower fees, a management team focused on long term capital gains rather than raising funds for follow-on funds.[99] Prohibitions on preferred redemption rights could limit seed capital for PCVs or other innovative structures, limiting the investment opportunity set available to investors.

G. Preferential Information Rights

103. The Proposal would prohibit advisers from providing preferential access to information about portfolio holdings or exposures.[100] The Commission argues that selective disclosure of portfolio holdings or exposures "can result in profits or avoidance of losses among those who are privy to the information beforehand at the expense of investors who did not benefit from such transparency. In addition, such information, could enable an investor to trade in portfolio holdings in a way that 'front-runs' or otherwise disadvantages the fund or other clients of the adviser."[101]

104. Although this rule is primarily aimed at private funds that either provide redemption opportunities to investors or which invest in publicly-traded securities, this prohibition may result in significant costs to private equity funds as well by not providing exemptions for situations in which a fund is expected to benefit from selective disclosure of portfolio investments. Specifically, the rule might be interpreted to prohibit selective disclosure of portfolio investment information which would be provided to investors with co-investing rights. The Proposal would prohibit selective information disclosure to investors in a "substantially similar pool of assets," defined as "a pooled investment vehicle "with substantially similar investment policies, objectives, or strategies to those of the private fund managed by

[99] Coghlan, Samantha Lake, and Ravi Chopra, "The rise of permanent capital," IPE Real Assets, September-October 2017, available at: https://realassets.ipe.com/investment-vehicles/the-rise-of-permanent-capital/10020839.article.

[100] The Proposal, page 166.

[101] The Proposal, page 166.

the adviser or its related persons."[102] Because co-investments fall under the same investment policies, objectives and/or strategies of the fund, there is a danger that this rule would prevent selective disclosure of co-investing opportunities.

105. A prohibition of selective disclosure of co-investing opportunities is likely to be detrimental to investors' interests. As discussed above, co-investing activity provides benefits to both co-investors (e.g., by providing lower cost investment opportunities and greater ability to control investment decisions) and funds (e.g., by providing access to investment opportunities that would be unavailable absent co-investors, and by providing co-investors' experience which might enhance deal performance). For these reasons, a prohibition on selective information disclosure without appropriate exemptions for co-investing opportunities, is likely to result in lower returns to investors and diminished investments with associated capital formation.

VI. PROPOSED DISCLOSURE PRACTICES

106. The Commission proposes various disclosure requirements aiming to improve transparency and in turn enhance competition.[103] The Proposal overlooks certain direct and indirect costs of the proposed rules which may instead create inefficiencies and harm competition. Costly disclosure practices with limited benefit may result in lower returns for the investors and diminish capital formation. Additionally, blanket disclosure requirements for all advisory firms will impose disproportionately large burden on smaller firms and weaken the competition posed by new industry entrants. Second, the Commission ignores situations where disclosure provides limited benefit and therefore is not worth the cost. Third, the Commission ignores the unintended consequences and incentives created by these disclosure requirements.

---

[102] The Proposal, page 167.

[103] It has been argued that private equity fees and returns are insufficiently transparent and potentially misleading to investors. However, I have not seen (i) any empirical evidence that investors are misled in making their investments in private equity, (ii) any empirical analysis of reasons why sophisticated investors are unable to obtain the information they desire to make investment decisions, nor (iii) any reasons why quality advisers in a competitive market do not provide additional information to bolster their relative reputation. Regulatory intervention as a solution to the alleged lack of transparency in the industry would only be warranted by evidence of a market failure. I am not aware of any such market failure in an industry with thousands of advisers and investors freely negotiating.

- The requirement to distribute quarterly statements within 45 days of each quarter end is likely to be administratively burdensome to certain advisers, and likely to provide little, if any, benefit to private equity investors who do not have redemption opportunities and would not benefit from timely information disclosures, and whose decisions to commit capital to follow-on funds are unlikely to be significantly impacted by more timely disclosures of recent interim financial results.

- Fee disclosures prior to final fund closing could interfere with negotiations, causing larger investors to be reluctant to be anchor or seed capital if their fee breaks are disclosed during the fund formation process. This may result in delays in fund formation, lower returns to investors, and diminished competition from small or new advisers that require anchor or seed capital as a signaling mechanism to attract other investors.

- The requirement of reporting results excluding the effect of subscription lines is unlikely to be beneficial in producing more comparable results, as there is no agreed-upon methods for such calculations. Excluding the effect of subscription lines is also likely to deflate fund returns below actual returns, obscuring the benefits of subscription lines to investors.

- Mandatory audits will create additional costs for funds not currently audited. Although the Commission argues that audits may limit advisers' inflation of interim fund results to facilitate raising capital for follow-on funds, research discussed below shows that investors are sophisticated and can see through manipulation. Leeway under accounting rules in the valuation of illiquid assets limits the benefits of mandatory audits to uncover inflated asset valuations. Finally, auditor independence rules may significantly constrain the ability of currently unaudited funds to obtain audits from high quality auditors (who may otherwise already be auditing portfolio companies or other related entities), further weakening any potential benefits of required audits.

- The benefit of fairness opinion in adviser-led secondaries would be limited if (i) the value of the asset is small relative to the cost of a fairness opinion, (ii) or other mechanisms such as disclosures, a third-party involvement, competitive bidding, and deal structuring provide reassurance to investors regarding potential conflicts of interest.

A. Quarterly statements

1. 45-day requirement

107. The Proposal would require the preparation and distribution of quarterly statements within 45 days of each quarter end.[104] The Commission supports this rule with a cursory statement that "[b]ased on our experience, we believe advisers generally would be in a position to prepare and deliver quarterly statements within this period."[105] The Commission's discussion of the costs and benefits associated with quarterly statements does not contain any discussion of the costs and benefits of the 45-day requirement.[106]

108. It is my understanding that many industry participants believe that a 45-day requirement will be administratively burdensome, and potentially not practical for many advisers and/or funds. This may be particularly the case for advisers who must report to hundreds or thousands of LPs, across multiple funds, with hundreds of portfolio companies. Note that many advisers would not only need to fulfill the Commission's proposed quarterly reporting requirement but would also need to meet additional reporting requirements where individual LPs have their own specific reporting requirements.

109. The benefits of a 45-day requirement in the private equity sector are likely to be small (if any). Because private equity investors generally cannot redeem their investments, the benefits of interim financial reporting are primarily to assist in portfolio monitoring and as additional information considered in making

[104] The Proposal, page 85.

[105] The Proposal, page 86.

[106] The Proposal, pages 232.

commitments to potential follow-on funds. However, because fundraising typically takes over a year until final close and LPs consider a wide range of information beyond recent adviser performance, it is unlikely that more timely reporting of a recent quarter's financial results would significantly impact an LP's decision to commit capital to a follow-on fund.[107] Given the small (if any) benefits to private equity LPs from a 45-day reporting requirement, the likely additional administrative burden is likely to exceed the value of such benefits.

2. Fee disclosures

110. The Proposal "would require an investment adviser that is registered or required to be registered to prepare and distribute quarterly statements with certain information regarding fees and expenses, including fees and expenses paid by underlying portfolio investments to the adviser or its related persons"[108] due to concerns that "[o]paque reporting practices make it difficult for investors to measure and evaluate performance accurately and to make informed investment decisions."[109]

111. As discussed elsewhere in this report, the increasing demand for private equity advisory services suggest that investors are satisfied with the level of information provided to them. Consistently, research shows that private equity investors are sophisticated enough to assess disclosures of the private equity advisors and furthermore can see through manipulation in returns if any. [110] This literature is discussed in detail in the discussion of mandatory audits below.

112. Note that funds might have multiple rounds of financing and the average time to close a fund is typically over a year.[111] First round of financing would be particularly important for a fund because first round demand serves as a signal to other investors. Under the proposed rule, an anchor or seed investor which might get a better term in

[107] Time until final close based on data from PitchBook.

[108] The Proposal, page 24.

[109] The Proposal, page 26.

[110] Brown, Gregory W., Oleg R. Gredil, and Steven N. Kaplan. "Do private equity funds manipulate reported returns?." *Journal of Financial Economics* 132.2 (2019): 267-297.

[111] Based on data from PitchBook.

the first round of financing may be more reluctant to invest early because later stage investors might ask for the same benefits provided to anchor investor. To the extent fees are fully required to be disclosed quarterly starting from the second full calendar quarter of operating results (and prior to final close on fundraising), later round investors would be able to infer preferential fee structures provided to early round investors, providing them an informational advantage in negotiations that would not be available to first-round investors. In this context, investors might choose to wait for later rounds of financing to commit capital in order to benefit from the disclosures of fees after the early rounds. Overall, this is likely to make early round fundraising more difficult, potentially slowing the fund formation process, with the resulting harm to capital formation by delayed commitment of capital.[112]

3. Subscription facilities

113. The Proposal would require advisers of illiquid funds to calculate performance without the effect of fund-level subscription facilities.[113] That is, the Commission propose that fund performance be reported by excluding the interest expense and any other costs associated with a fund-level subscription line of credit. The Commission argues that "'levered' performance figures often do not reflect the fund's actual performance and have the potential to mislead investors."[114] The Commission also argues that excluding fees and expenses associated with a subscription facility (e.g., interest expense) "would cause the net returns for many funds to be higher than would be the case if such amounts were included."[115]

114. There are several issues associated with the Commissions requirement for illiquid funds to calculate performance excluding the impact of subscription facilities. First, the Commission is mistaken that the levered performance obscures "actual" performance. If a fund uses subscription facilities, then the actual performance would

[112] Fund-level fee disclosures will make apparent to investors whether they are paying above or below the average fee across the fund. Depending on the amount of information disclosed, sophisticated investors may be able to use fund level information to infer fees for individual investors.

[113] The Proposal, page 67.

[114] The Proposal, page 69.

[115] The Proposal, page 70.

properly include the impact of borrowing. Although excluding the impact of subscription facilities might or might not improve comparability of performance information across funds, it does not provide a better view of "actual" performance. By a simple analogy, publicly traded companies regularly report earnings based on actual corporate leverage, without any adjustment that puts different companies' financial statements on similar unlevered basis. Similarly, mutual funds and exchange-traded funds report actual results without adjustment for leverage. Sophisticated investors understand the effects of leverage and can ask advisers for any information that might help them assess returns.

115. Second, the Commission is mistaken that excluding the impact of subscription facilities would necessarily increase net returns. Although removal of the expenses associated with subscription facilities would increase income, such increases in income would be offset by the impact of adjusting returns calculations to reflect that capital calls would have been earlier absent the use of the subscription line. Any calculation of performance absent the effect of a subscription line will require assuming the fund had called investor capital at earlier times rather than drawing down the subscription line to fund investments. Earlier capital calls would, all else equal, decrease investor IRRs. One study found that a subscription line *increases* fund IRRs by about 0.2% to 0.5%, based on median and mean estimates from simulated fund performance.[116] Thus, one would expect for the typical fund excluding the impact of a subscription line would *decrease* fund returns.[117] Moreover, this study also found the impact of subscription lines on a performance multiple such as distributions to paid-in-capital (DPI) is very small (median impact of -0.02x), and

[116] Blackrock, "Analyzing the impact of subscription lines on private equity fund characteristics," August 2019. See, also, Pierre Schillinger, Reiner Braun and Jeroen Cornel, "Distortion or Cash Flow Management? Understanding Credit Facilities in Private Equity Funds," Working Paper, February 2020.

[117] The Proposal includes a prohibition on advisers borrowing from a fund but does not include a prohibition on advisers lending to a fund. However, the Commission requested comments on whether such lending should be prohibited or restricted in some way (e.g., to ensure excessive interest rates are not charged). Where advisers are the providers of subscription lines of credit, such lending benefits the fund (e.g., by facilitating organizational activities or portfolio investment transactions). Any prohibition on such lending from the adviser to the fund could therefore harm fund LPs through foregone investment opportunities and/or delayed organizational activity. Moreover, because the adviser's interests in fund returns are generally aligned with the fund's investors through carried interest, such incentives mitigate the risk of excessive interest on subscription lines of credit. See The Proposal, pages 158-160.

therefore such metrics are already comparable across funds without the need for adjustment for the effect of subscription lines of credit.[118]

116. Third, it is my understanding that private equity funds typically provide investors information they request. To the extent a fund does not currently provide performance information with and without the impact of subscription line, an investor can request such information.

117. Fourth, it is not clear that removing the impact of subscription lines will necessarily enhance comparability of performance across funds. ILPA guidance notes that "there is not an agreed upon methodology for calculating performance with and without the use of subscription lines."[119] For example, to remove the impact of a subscription line one must make assumptions regarding the timing and magnitude of capital calls in the absence of a subscription line. Assumptions about the timing of capital calls can have a large impact on IRR, particularly early in a fund life.[120] Thus, the Commission may be incorrect regarding whether there would be any benefit to investors of enhanced cross-fund comparability from requiring performance to be reported excluding the effect of subscription lines.

B. Mandatory audits

118. The Proposal would "require private fund advisers to obtain an annual audit of the financial statements of the private funds they manage."[121] The Commission is concerned that "fund's adviser may use a high level of discretion and subjectivity in valuing a private fund's illiquid investments, which are difficult to value. This creates a conflict of interest if the adviser also calculates its fees as a percentage of the value of the fund's investments and/or an increase in that value (net profit), as is typically the case.

---

[118] Blackrock, "Analyzing the impact of subscription lines on private equity fund characteristics," August 2019. See, also, Pierre Schillinger, Reiner Braun and Jeroen Cornel, "Distortion or Cash Flow Management? Understanding Credit Facilities in Private Equity Funds," Working Paper, February 2020.

[119] Institutional Limited Partners Associated, "Enhancing Transparency Around Subscription Lines of Credit," June 2020.

[120] "The impact of use of a line of credit on IRR will be greatest early in the life of the fund…" Institutional Limited Partners Associated, "Enhancing Transparency Around Subscription Lines of Credit," June 2020.

[121] The Proposal, page 99.

Moreover, private fund advisers often rely heavily on existing fund performance when obtaining new investors (in the case of a private fund that makes continuous or periodic offerings) or fundraising for a new fund." [122]

119. As a preliminary matter, the conflict-of-interest concern regarding fees is more applicable to private funds such as hedge funds which might charge management fees on the basis of fund net asset values. Private equity funds typically charge management fees based on capital commitments, or sometimes invested capital, neither of which is affected by subjective valuation methods. On the other hand, private equity funds report interim performance (e.g., IRRs and fund returns) that reflects valuations of illiquid investments. In the context of private equity funds, the Commission's only stated concern justifying the proposed audit requirement, then, is if fundraising for follow-on funds might present a conflict of interest as advisers determine interim fund performance based on subjective valuations.[123]

120. The Commission cites research that documents an empirical pattern of greater returns around the fundraising for the follow-on fund with a gradual reversal once the follow-on fund is closed.[124] Another empirical finding in the literature is that the high interim returns improve the fundraising prospects of the adviser for the next fund. However, these empirical observations do not show there is inflation in the value of illiquid assets nor that investors are deceived by the high interim returns as I explain below.

121. "A fund's interim performance has two components: (1) exited investments to date and (2) the net asset value (NAV) of unrealized investments."[125] To the extent current fund performance helps with fundraising, an adviser can fundraise in the wake

---

[122] The Proposal, page 99.

[123] The Commission also argues that an audit requirement may assist in its enforcement efforts because auditors would be required to notify the Commission of an auditor's termination or issuance of modified opinions, in contrast to no such notifications required under the custody rule's annual surprise examination framework. The Proposal, pages 102-103.

[124] Jenkinson, Tim, Miguel Sousa, and Rüdiger Stucke. "How fair are the valuations of private equity funds?." *Available at SSRN 2229547* (2013).

[125] Barber, Brad M., and Ayako Yasuda. "Interim fund performance and fundraising in private equity." *Journal of Financial Economics* 124.1 (2017): 172-194.

of either a successful investment exit or after reporting unrealized gains. Note that the literature finds that portfolio companies follow conservative accounting after realizing successful exits: funds are valued "24% to 56% below the final exit values in the quarter prior to the exit quarter" or 35% lower than implied by the subsequent distributions.[126] Barber and Yasuda find support for the exit strategy approach and state that "interim performance is more important for fundraising success when it is backed by good exits." [127] They find that "GPs appear to fundraise on the heels of good exits. Consistent with the exit and fundraise story, performance peaks are greatest for funds with high realization rates at the time of fundraising." [128] Note that a fundraising at the time of peak performance does not necessarily show inflated returns but rather may reflect informed timing by the adviser (i.e., GPs time the launch of fundraising based on interim results, rather than changing interim results to fit a fixed fundraising timeline). Mandatory audits would not change such patterns. Barber and Yasuda find limited evidence of inflating the asset values only for low reputation advisers without a strong exit. [129]

122. A related study argues that write-offs following a fundraising increase "as a result of the effort-rationing by the GP between the newly-raised fund and the old fund."[130] This study finds that "some underperforming managers inflate reported returns during times when fundraising takes place. However, those managers are less likely to raise a next fund, suggesting that investors can see through the manipulation on average."[131] In other words, even if "low reputation" managers might have incentives

---

[126] Barber, Brad M., and Ayako Yasuda. "Interim fund performance and fundraising in private equity." *Journal of Financial Economics* 124.1 (2017): 172-194.

[127] Barber, Brad M., and Ayako Yasuda. "Interim fund performance and fundraising in private equity." *Journal of Financial Economics* 124.1 (2017): 172-194.

[128] Barber, Brad M., and Ayako Yasuda. "Interim fund performance and fundraising in private equity." *Journal of Financial Economics* 124.1 (2017): 172-194.

[129] Barber, Brad M., and Ayako Yasuda. "Interim fund performance and fundraising in private equity." *Journal of Financial Economics* 124.1 (2017): 172-194.

[130] Brown, Gregory W., Oleg R. Gredil, and Steven N. Kaplan. "Do private equity funds manipulate reported returns?." *Journal of Financial Economics* 132.2 (2019): 267-297.

[131] Brown, Gregory W., Oleg R. Gredil, and Steven N. Kaplan. "Do private equity funds manipulate reported returns?." *Journal of Financial Economics* 132.2 (2019): 267-297.

to inflate reported returns to assist in fundraising, evidence suggests that sophisticated investors are not swayed by such results. Requiring an audit for such funds (to the extent they are not already audited) will raise costs to investors, with limited, if any, benefits to current or potential future investors. The study concludes that "sophisticated LPs are, on average, unlikely to misallocate capital and may therefore prefer the current stance to one with more regulation and (possibly) less gaming." [132]

123. The literature discussed above confirms that private equity investors are sophisticated enough to see through manipulations and there are various economic reasons (such as high realized returns, optimal fundraising timing, or effort-rationing) for the peak returns around the fund raising that would not change with auditing. Therefore, the benefit of mandatory audits would be very limited. On the other hand, the cost of annual audits can be significant especially for smaller funds (where such funds are not part of a group of related funds which can spread the fixed costs of an audit across a wider investor base).

124. Moreover, even if there were specific instances in which the requirement of an audit might limit overstated performance in private equity firms, a blanket audit requirement for all funds is likely to impose costs in situations where there is no such benefit. For example, if an adviser managed a small fund for "friends and family" investors and had no intention of raising follow-up funds, the added costs of an audit would be detrimental to those investors without any corresponding benefit.

125. An audit requirement will not, in and of itself, necessarily solve conflict of interests in private equity valuations of illiquid investments. First, auditors themselves have incentives to be rehired, and therefore may have incentive not to challenge valuations that can be reasonably justified as within the bounds of accounting rules. Second, accounting rules provide for significant leeway in valuation of illiquid assets such that there may be an audit-accepted margin of error in such valuations, and research finds that the informativeness of fair value measurements in financial statements "is affected by the amount of measurement

[132] Brown, Gregory W., Oleg R. Gredil, and Steven N. Kaplan. "Do private equity funds manipulate reported returns?." *Journal of Financial Economics* 132.2 (2019): 267-297.

error and source of the estimates – management or external appraisers."[133] Sophisticated investors are aware of the limits of what a "clean" audit opinion means and, therefore, may discount the incremental value of such information above information conveyed by management regarding the valuation method, assumptions, and the use of third party appraisers.[134] Such sophisticated investors might benefit more from simple disclosure of valuation methods and whether third party appraisers were used, both of which may be information that the investor can request from an advisor if not already provided.

126. Finally, the Commission does not consider reasons that some funds are not currently audited.[135] It is my understanding that funds may not have an auditor in cases where auditor independence rules present barriers to finding a quality auditor. For example, fund agreements or portfolio companies may have requirements to use "Big 4" auditors which could lead to violations of auditor independent rules given the limited number of such auditors and the number of portfolio companies. In such circumstances, requiring an audit may require renegotiation of contracts which place limitations on audit firm selection (e.g., "Big 4" only) or force the fund to use auditors that may be perceived as lower quality. Research has shown that investors value an auditor's quality. For example, research has found that the association between mutual fund reported performance and investment flows is stronger where fund auditors are specialists, longer-tenured, and charge higher audit fees.[136] The opinions of lower quality auditors would, therefore, provide less benefit, if any, to investors and may not necessarily add any value in excess of the audit cost.

---

[133] Wayne R. Landsman, "Is fair value accounting information relevant and reliable? Evidence from capital markets research," *Accounting and Business Research*, 37:sup1, February 2021, 19-30.

[134] That is, while qualified or adverse audit opinions may convey information to investors, an unqualified opinion may not necessarily convey that financial statements are free from any effects of subjective asset valuation determinations.

[135] The Commission acknowledges that such funds may be subject to annual surprise examinations under the custody rule, which would provide incentive for robust compliance with financial reporting standards. The Proposal, pages 101-102.

[136] Bradley A. Goldie, Lei Li, and Adi Masli, "Do Mutual Fund Investors Care About Auditor Quality?" *Contemporary Accounting Research*, 35:3, Fall 2018, 1505-1532.

C. Adviser-led secondaries

127. 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."[137] In addition to a fairness opinion from an independent opinion provider, the rule would require disclosure of "any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider."[138]

128. The Proposal does not consider situations in which a fairness opinion may be of limited benefit, or where the costs of such an opinion (which, will ultimately be borne by the investors), outweigh the benefits. A fairness opinion may be of limited benefit, for example, for assets whose valuations are subject to considerable estimation uncertainty within reasonable valuation methodologies and assumptions. If the value of the asset in question were small, the costs of a fairness opinion could exceed any benefits to investors from any revision in transaction price that might result from such an opinion. If a third party without a conflict of interest is involved in the transaction as a co-investor, this might validate the price for the investors and make the fairness opinion an unnecessary burden.[139] To the extent the risk that the transaction price may be inappropriate is a factor that investors can consider, and they are always able to request a fairness opinion. Under the existing framework investors look to many factors in evaluating potential conflicts-of-interest in a GP-led deal, such as disclosures, deal terms with earnouts and deferred purchase price payments, clear rationales for the deal, optionality to the fund LPs to participate in the deal or take liquidity, competitive bidding (e.g., dual-track exploration of traditional M&A

[137] The Proposal, page 121.

[138] The Proposal, page 122.

[139] For example, attorneys involved in one GP-led secondary transactions reported being "involved in a single-asset transaction where a fairness opinion offered less utility because as a part of the transaction the GP sold a minority stake in the underlying asset to a third party in concert with the transaction involving existing and new LPs. This sale provided a non-affiliate valuation assessment of the asset and mitigated many concerns about conflicts of interests and deal pricing." "Defining the narrative on GP-led deals," *GP-led Secondaries*, Private Equity International, March 2021.

exit and GP-led secondary exit), and involvement of advisors to address conflict and fair treatment issues.[140] Moreover, sophisticated investors are free not to participate in the transaction if they deem the risks associated with a lack of fairness opinion outweigh the benefits of participating. Overall, a blanket requirement is likely to impose costs in excess of benefits in some subset of adviser-led transactions, and, where the benefits exceed the costs, advisers have incentive to obtain fairness opinions to encourage investor participation in the transaction.

129. The cost of a fairness opinion will vary with transaction-specific factors. One industry source states that fairness opinions for lower and middle market private companies cost about $50,000 to $100,000, and that more sophisticated deals can have higher costs, potentially more than $1 million.[141] The cost of fairness opinions are typically at a premium to the costs of appraisals due to the risks to the opinion provider given that the opinion may be used in litigation and must therefore have a high degree of reliability. The Commission's analysis, on the other hand, assumes an average of $40,849 cost to external parties for both the fairness opinion and material business relationship summary. This assumption is too low, as it likely underestimates the effect of complicated, costly fairness opinions on average. Additionally, the Commission's assumption of the cost of a fairness opinion does not consider that many GP-led secondary transactions involve multiple assets, which would have more costly fairness opinions depending on the number and complexity of assets involved.[142]

130. The Commission does not consider the relative burden and benefit of disclosures of the fairness opinion provider's material business relationships with the adviser or its related persons. Because the Commission does not provide a definition of what constitutes a "material business relationship" there is potential difficulty complying with this requirement and diminished usefulness of the relationship summary to

---

[140] See *GP-led Secondaries*, Private Equity International, March 2021.

[141] This source advises that "advisors providing opinions for $10,000 or $20,000 shouldn't be taken seriously." Vantage Point Advisors, "How Much Do Fairness and Solvency Opinions Cost?", available at: https://vpadvisors.com/blog/cost-of-fairness-solvency-opinions

[142] See *GP-led Secondaries*, Private Equity International, March 2021.

investors. In order to provide this summary, fairness opinion providers will need databases of their business relationships. Such databases may be costly to build and maintain, particularly for fairness opinion providers that have multiple lines of business other than that of providing fairness opinions. Moreover, with each fairness opinion the adviser will need to disclose a complete list of all "related persons," which will, in turn, require active management of such information. The Commission does not assess the cost of developing and maintaining these databases. Such cost may be particularly high for the largest, most reputable fairness opinions providers who have multiple lines of business.[143] It is likely that fairness opinion providers will raise their fees to compensate for the additional administrative burden, thus rendering the Commission's estimate of third party costs of fairness opinions too low.

VII. SIGNATURE AND RIGHT TO MODIFY

131. This statement represents my opinions at this time. However, as I have noted earlier in this report, I may supplement this statement if new information is made available to me.

S.P. Kothari

April 25, 2022

[143] As of 2020, Business Valuation Resources lists the top five global M&A fairness opinion providers as Stout, Duff & Phelps, Houlihan Lokey, J.P. Morgan, and Piper Sandler, "Fairness opinion provider rankings for 2020," BVWire, Issue #221-2, February 10, 2021, available at: https://www.bvresources.com/articles/bvwire/fairness-opinion-provider-rankings-for-2020.

AIC Comment Letter to SEC Release No. IA-5955

APPENDIX 2

Report of Professor Mark J. Flannery

Proposed Rules for Private Fund Advisers

Mark J. Flannery, Ph.D.[1]
Bank of America Eminent Scholar in Finance
Warrington College of Business Administration, University of Florida

April 25, 2022

[1] Professor Flannery served as the Chief Economist and Director of the Division of Economics and Risk Analysis at the SEC from 2014 to 2016. He previously worked with other U.S. regulatory agencies: part-time Senior Adviser to the Office of Financial Research from 2011 to 2014, the New York Fed's Financial Advisory Roundtable (2006- 2014) and the Federal Reserve System's stress-test-related Model Validation Council (May 2012-2014, chair 2013- 2014). In 2003, he helped establish the FDIC's Center for Financial Research and then served as co-director and senior adviser until 2007. Professor Flannery holds economics degrees from Princeton (A.B.) and Yale (M.A., M.Phil., and Ph.D.).

I. INTRODUCTION

A. Executive Summary

1. The U.S. Securities and Exchange Commission ("SEC") has proposed new rules that fundamentally and dramatically alter the regulatory regime for private funds, prohibiting some widely accepted practices and imposing new regulatory and disclosure requirements on private fund advisers.[2] The proposed rules appear to be motivated by the Commission's assessment that a substantial proportion of private fund investors are misled or confused. The Proposal identifies several features of private funds' operations that the Commission identifies as potentially interfering with some limited partners' (LPs) ability to understand likely returns or to compare fees (costs) and liquidity restrictions across available funds. The Proposal appears to maintain that social policy or successful capital formation requires that all investors in a private fund be treated the same for certain types of contractual rights, although different treatments of certain contractual rights may be permissible so long as specific disclosures are made.

2. As I detail below, the Proposing Release fails to provide a meaningful justification for why these proposed new rules are needed. In this and other ways, the economic analysis presented in the Proposing Release is deficient when evaluated against the SEC's own standards. In particular, the economic analysis fails to demonstrate a problem that requires the proposed rules to solve, contradicts (without explicit discussion) the SEC's recent reclassification of accredited investors, and fails to consider both a number of significant costs and reasonable alternatives.

3. The remainder of this paper is organized as follows: Section I.B provides details on the proposed rules and discusses at a high level how those proposed rules may change the nature of private fund investing. Section II discusses the role of the economic analysis in the rulemaking process, focusing on the aspects necessary for it to fulfill the requirements of the SEC's recent guidance. Section III evaluates systematically whether the economic analysis in the Proposing Release is complete, rigorous, and sufficient to support a fully informed assessment of the economic impact of the proposed rules. Section IV concludes.

---

[2] *Private Fund Advisers: Documentation of Registered Investment Adviser Compliance Reviews,* Advisers Act Release No. 5955 (Feb 9, 2022) ("Proposing Release" or "Proposal"). The opinions stated in this comment letter reflect preliminary findings based on the proposing release and the limited time given for comments. I reserve the right to supplement my analyses and opinions in the event that additional time for review of the proposing release is granted.

B. Overview of the Proposed Private Funds Rules

4. On February 9, 2022, the SEC proposed a series of rules that, if adopted, would impose new prohibitions on the business practices commonplace in private fund investing. If implemented, these prohibitions would fundamentally change the landscape of private fund investing and would alter how private fund advisers contract with the funds' investors. Importantly, these prohibitions apply to *all* private fund advisers, whether or not they are registered with the SEC, and regardless of the composition of a fund's limited partners. The proposed prohibitions include:

i. Seeking reimbursement, indemnification, exculpation, or limitation of the adviser's liability for certain activity.[3]

ii. Engaging in certain types of preferential treatment.[4]

iii. Charging fees for unperformed services (e.g., accelerated monitoring fees) and fees associated with an examination or investigation of the adviser or regulatory and compliance expenses of the adviser.[5]

iv. Reducing the amount of an adviser's clawback by the amount of certain taxes.[6]

v. Charging fees or expenses related to a portfolio investment on a non-pro-rata basis.[7]

vi. Borrowing or receiving an extension of credit from a private fund client.[8]

5. Effectively, these prohibitions would amount to outright bans on the activities listed above, some of which are common and widely accepted in currently-operating private funds. Regardless of prior disclosure, authorization in fund governing documents, or approval from LPs, the specified activities of any investment adviser would be unlawful under the proposed rules. The SEC appears to believe that such bans are the only way to "address conflicts of

---

[3] Proposed rule 211(h)(2)-1.

[4] Proposed rule 211(h)(2)-3.

[5] *See* Proposed rule 211(h)(2)-1.

[6] *See* Proposed rule 211(h)(2)-1.

[7] *See* Proposed rule 211(h)(2)-1.

[8] *See* Proposed rule 211(h)(2)-1.

interest that could … incentivize investment [advisers] to place [their] interests ahead of the private fund's interest."[9]

6. In Section III, below, I describe in detail the shortcomings of the economic analysis associated with these proposed prohibitions. It is worth noting here, however, that the SEC's proposed prohibitions would have a significant economic impact on the investing landscape. In particular, prohibiting indemnification, exculpation, and the limitation of the adviser's liability for certain activities would likely change (i) which investors have access to private funds and (ii) the incentives of fund sponsors to make the opportunistic investments necessary to generate the high risk-adjusted returns they have historically achieved. Both of these outcomes are suboptimal compared to the status quo. Fund management teams require indemnification with respect to their activities conducted in connection with funds and accounts because they would otherwise bear a disproportionate amount of litigation risk relative to their potential return. This is analogous to the rationale for the widely-prevalent practice of indemnifying directors and officers of corporations. Without indemnification for their actions as agents for funds and accounts, the management team would naturally demand higher compensation or profit sharing for their activities. Since management teams would need to be willing to accept a higher degree of risk, relative to reward, if indemnification were not provided, the quality of available management teams would likely be reduced in general.

7. Regarding fee negotiations, Proposed Rule 211(h)(2)-1 would place new restrictions on the adviser's ability to customize contracts across investors. The proposed rules prohibit allocating expenses related to portfolio investments in any way other than pro rata.[10] For example, Proposed Rule 211(h)(2)-3 would disallow all private fund advisers from (i) providing preferential redemption terms to certain investors in private funds or in substantially similar pools of assets (such as parallel funds), or (ii) providing certain information about portfolio holdings or exposures only to certain private fund investors if the adviser reasonably expects such preferential terms or information to have a material, negative effect on other investors in the private fund.[11] Such prohibitions ignore the evidence that some LPs provide benefits to fund advisers and to a fund's portfolio firms. Many LPs can negotiate lower fees due to the amount of capital they provide (e.g., anchor investors), the point-in-time at which they provide it (e.g., seed investors), or due to other tangible benefits such as help with fundraising and specific expertise relevant to portfolio investments.

---

[9] "Fact Sheet Private Fund Proposed Reforms," SEC, Advisers Act Release No. 5955 (February 9, 2022) ("Fact Sheet").

[10] *See* Proposed rule 211(h)(2)-1.

[11] *See* Proposed rule 211(h)(2)-3.

Although some LPs can negotiate better terms, those benefits do not come at the expense of other, smaller LPs. To the contrary, benefits negotiated by large LPs often trickle down to all investors. The Commission's failure to account for the benefits provided to all fund investors through negotiations of some LPs represents a significant oversight in its economic analysis.

8. Types of "preferential treatment" would be allowed, but only if accompanied by advanced written notice to prospective investors and an annual written notice to current investors. The SEC leaves "preferential treatment" largely undefined, noting only that "[w]hether any terms are 'preferential' would depend on the facts and circumstances."[12] In such cases, it appears that the SEC's theory is that other types of preferential treatment do not necessarily disadvantage other fund investors, so long as appropriate disclosures are made. Alternatively, an adviser could comply with the proposed requirements by providing copies of Side Letters (with identifying information regarding the investors redacted) or a written summary of the preferential terms provided to investors, so long as the summary specifically describes the preferential treatment.[13] If LPs cannot modify their existing agreements if and when additional "preferential terms" are disclosed, the protection afforded to LPs seems limited. And if they can modify existing agreements, the time (costs) required to set up a new fund could be greatly extended (increased).

9. In addition to the above prohibitions, the proposed rules would also impose costly new regulatory requirements on private fund advisers, including:

i. Annual audited financial statements for private funds ("Proposed Audit Rule)."[14]

ii. Quarterly statements that describe in detail the costs of investing in the private fund and the private fund's performance ("Proposed Quarterly Statement Rule").[15]

iii. Fairness opinions for adviser-led secondary transactions ("Adviser-Led Secondary Rule").[16]

---

[12] Proposing Release, p. 163.

[13] Proposing Release, p. 170.

[14] Proposed rule 206(4)-10.

[15] Proposed rule 211(h)(1)-2.

[16] Proposed rule 211(h)(2)-2.

10. The Proposed Audit Rule appears to be motivated by the SEC's belief that absent such an audit, investors are not adequately protected against "the misappropriation of fund assets,"[17] nor are they protected against the possibility of an adviser inflating private fund asset values, "which often serve as the basis for the calculation of the adviser's fees."[18] Beyond simply requiring an audit, the Proposal mandates that the audit: be performed by an independent public accountant, be performed at least annually and upon liquidation, in accordance with Generally Accepted Accounting Principles as promulgated in the United States ("U.S. GAAP"), or for financial statements of non-U.S. funds or funds with a general partner with a principal place of business outside the U.S., contain information substantially similar to statements prepared in accordance with U.S. GAAP and with any material differences reconciled, and distributed "promptly" after completion of the audit to current private fund investors.[19]

11. The Proposed Quarterly Statement Rule appears to be motivated by the SEC's belief that fund investors do not have adequate information to understand the fees and assess the performance of their investments. This is in spite of the academic literature cited by the SEC, which concludes "investors consistently select or are offered the best fee structure in their respective funds, at least in terms of ex-post performance."[20] To address this alleged information gap, the Proposed Quarterly Statement Rule would require registered private fund advisers to distribute a quarterly statement to private fund LPs that includes certain specified information regarding fees, expenses, and returns. Fee and expense disclosures would include: (i) a detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the private fund during the reporting period, (ii) a detailed accounting of all fees and expenses paid by the private fund during the reporting period ("fund expenses"), and (iii) the amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons.[21] Required performance disclosures would include certain portfolio company ownership and performance information, including: (i) for open-end funds, annual net total returns since inception, average annual net total returns, and quarterly net total returns, and (ii) for closed-end funds,

---

[17] Proposing Release, p. 290.

[18] Proposing Release, p. 290.

[19] Proposing Release, pp. 328–329.

[20] Juliane Begenau and Emil Siriwardane, "How Do Private Equity Fees Vary Across Public Pensions?," Harvard Business School 20-073 (Working Paper), February 2021.

[21] Proposing Release, pp. 335–336.

gross and net internal rate of return and gross and net multiple of invested capital.[22] The SEC states that:

> Periodic statements detailing such information are necessary to improve the quality of information provided to fund investors, allowing them to assess and compare their private fund investments better. This information also would improve their ability to monitor the private fund adviser to ensure compliance with the private fund's governing agreements and disclosures. While private fund advisers may currently provide statements to investors, there is no requirement for advisers to do so under the Advisers Act regulatory regime.[23]

12. Under the Proposed Quarterly Statement Rule, private fund advisers would be required to distribute these reports to investors within 45 days following the end of the applicable quarter. The SEC contends that such information, provided in a standardized tabular format, would help inform investment decisions, and in particular, "whether to remain invested in certain private funds or to invest in other private funds managed by the adviser or its related persons."[24] It is unclear that such a rule is necessary to inform these types of decisions, as investors routinely make them under the current regime and the SEC provides no evidence that such decisions are uninformed or otherwise inefficient.

13. The proposed Adviser-Led Secondary rule would require registered advisers to distribute to fund investors, prior to completing an adviser-led secondary transaction, (i) a fairness opinion from an independent opinion provider and (ii) a summary of any material business relationships the adviser (or any of its related persons) has, or has had, within the past two years with the independent opinion provider.[25] The SEC argues that such a rule "would provide an important check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors."[26]

14. Finally, the proposed rules would amend the Advisers Act compliance rule to require all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing in order to facilitate the SEC staff in determining whether those advisers have complied with the review requirement of the proposed rules.[27] However, the proposed amendment does not specify which reporting elements must be included in the

---

[22] Proposing Release, pp. 63–64, 67.

[23] Proposing Release, p. 18.

[24] Proposing Release, p. 19.

[25] Proposing Release, pp. 121–122.

[26] Proposing Release, p. 122.

[27] Proposing Release, p. 178

written documentation. Instead, the SEC recites the requirements of Rule 38a-1 under the Investment Company Act, which requires, among other things, an annual compliance report to a registered fund's board of directors, including (i) the operation of the compliance policies and procedures of the registered fund and each investment adviser of the registered fund; (ii) any material changes made to those policies and procedures since the date of the last report; (iii) any material changes to the policies and procedures recommended as a result of the annual review of its policies and procedures; and (iv) each material compliance matter that occurred since the date of the last report.[28]

15. In sum, the proposed new rules would impart significant changes to how private fund advisers conduct business and would likewise impose significant changes to how LPs and other private fund investors are able to negotiate and access private funds. The SEC justifies these proposed changes by pointing to largely anecdotal evidence regarding practices they have observed "during [their] decade overseeing most private fund advisers."[29] In particular, the SEC points to the enforcement actions against private fund advisers for practices that resulted in investors "pay[ing] more in fees and expenses than they should have, which negatively affected returns for private fund investors, or resulted in investors not being informed of relevant conflicts of interest concerning the private fund adviser and the fund."[30] The SEC argues that despite these enforcement actions, these types of activities persist, presumably necessitating the proposed rules.

16. This sentiment is echoed in the Discussion of Proposed Rules for Private Fund Advisers Section of the Proposing Release:

> We are proposing a series of rules under the Advisers Act that would specifically address these practices by advisers to private funds. The goal of this package of proposed reforms is to protect those who directly or indirectly invest in private funds by increasing visibility into certain practices, establishing requirements to address certain practices that have the potential to lead to investor harm, and prohibiting adviser activity that we believe is contrary to the public interest and the protection of investors.[31]

17. Upon review, the SEC's justification for the proposed rules is both insufficient and unsupported. As an initial matter, the SEC justification relies on the underlying assumption that all LPs require the same type and level of protection. This assumption is wholly incorrect. There is substantial heterogeneity among LPs, both in terms of size and

---

[28] Proposing Release, pp. 180–181.

[29] Proposing Release, p. 9.

[30] Proposing Release, p. 9.

[31] Proposing Release, p. 17.

experience, and the proposed rules will affect different LPs in different ways. Each LP has its own particular requirements with respect to its private fund investments and, under the current regime, each can negotiate accordingly. Under the proposed rules, however, it is unclear whether these negotiations will result in substantially similar outcomes to present, or whether some LPs will have their freedom to contract impinged, resulting in suboptimal outcomes for certain LPs. The SEC's justification therefore relies, in part, on evaluating the tradeoffs between the potential benefits to some LPs and the potential costs imposed on others. However, the SEC does not endeavor to calculate this tradeoff but rather assumes that all LPs will benefit from the proposed rules, even though they present no evidence to support this assumption.

18. Moreover, the economic analysis presented in the Proposing Release fails to support the stated justifications for regulatory intervention in an important market that has grown rapidly in recent years. In particular, the economic analysis fails to demonstrate a problem that requires the proposed rules to solve, contradicts the SEC's recent reclassification of accredited investors, and fails to consider both a number of significant costs and reasonable alternatives. In the sections that follow, I first describe the role of the economic analysis in the rulemaking process, and then detail how the economic analysis of the Proposing Release fails along every measure.

II. THE ROLE OF ECONOMIC ANALYSIS IN SEC PROPOSALS

19. By its own standards and applicable requirements, a proposed SEC regulation should include a detailed economic analysis, which identifies the important costs and benefits of a proposed rule relative to the status quo ("baseline").[32] A rigorous economic analysis helps the SEC consider whether rulemaking is needed and whether proposed rules achieve desired policy goals in the most efficient manner.

20. While serving as the SEC's Chief Economist from 2014-2016, I oversaw the production of these economic analyses to assure that they were economically valid and complete. According to guidance developed by the SEC's economists and the general counsel's office,

[32] The SEC Guidance requires that any proposed rulemaking "(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 the cannot be quantified." *See* Memorandum on Current Guidance on Economic Analysis in SEC Rulemaking, March 16, 2012 ("SEC Guidance"), pp. 9–10. The SEC Guidance also advocates for combining the analysis of costs and benefits with the economic effects on Efficient, Competition, and Capital Formation, in order to reduce "redundancy and unnecessary parsing of economic effects." SEC Guidance, p. 14.

and published by the SEC in 2012, an economic analysis for rulemaking must include four specific components:

i. Identifying the need for the rulemaking and explaining how the proposed rule will meet that need.

ii. Articulating the appropriate economic baseline against which to measure the proposed rule's likely economic impact.

iii. Identifying and evaluating reasonable alternatives to the proposed regulatory approach.

iv. Assessing the potential economic impact of the proposed rule and reasonable alternatives.

21. The economic analysis identifies what the world would be like in the absence of a new regulation and attempts to measure the differential costs and benefits between that world (the "baseline") and one with the new regulation, going forward. An economic analysis must clearly identify how the new regulation would change things both immediately and in the longer run.

22. An identified problem situation needs to be addressed by rulemaking only if non-regulatory forces cannot improve or rectify the situation. Private funds attract only accredited investors.[33] Although the SEC's motivation for this Proposal is based on a belief that LPs cannot adequately take care of themselves, the Proposal also provides evidence that the SEC believes private fund LPs have a relatively high degree of financial sophistication. If sophisticated parties can negotiate contracts that reflect their own preferences and their acceptable tradeoffs among possibly multiple aims, why and how does government regulation abet the process? If government intervention were to help some private investors, might it not harm others who are content with their current contractual relations with private fund

[33] In fact, accreditation as defined by the SEC in 2020 is the lowest standard of financial sophistication present among a private fund's LPs. Most LPs are either accredited investors, meaning they (i) are a bank, private business company, or organization with characteristics as outlined in 17 CFR § 230.501, (ii) are a natural person who is either a director, executive officer, or general partner of the issuer of the securities being offered or sold, or an individual who meets net worth and/or income requirements, or (iii) are natural persons that have certain professional certifications, designations, or credentials, or (iv) parties that meet the other requirements outlined in 17 CFR § 230.501 and the amendments to Rule 501(a) passed in 2020, or otherwise meet more strict measures, such as those relating to qualified purchasers, qualified clients, or qualified institutional buyers.

advisers? In other words, why have market forces not produced efficient results here, leaving government regulation as the only feasible way to do so?

23. The defined baseline should include many assessments and assumptions about the state of the world. What are the facts, for example, about LPs' financial sophistication and their ability to negotiate different information transparency with a fund's investment adviser? An important part of the baseline is the extent of monopoly power in the investment adviser (IA) business, which will prominently affect the extent to which fund advisers are willing to take LPs' preferences into account when determining transparency.

i. If investment advisers all have market power and private funds are in short supply, LPs will have little bargaining power if they wish to be included in a particular fund.

ii. By contrast, if the IAs compete to attract investable resources, the supply of private funds should be substantial and LPs should be able to negotiate contractual terms that reflect their preferences and trade-offs. In particular, if the SEC has identified practices that are generally viewed negatively by LPs, an adviser that tried to impose these practices will find it more difficult to attract investments than one who offers some flexibility.

iii. There are many IAs offering private funds but, unfortunately, the Proposal and economic analysis provide no evidence about their market power. Yet this assessment should have a first-order impact on appropriate regulatory changes.

24. With a clear expression of the need for a new regulation, analysts should be able to identify multiple alternative, salutary policies that might be implemented. They will vary in their costs and in the extent to which they address the identified problem. The economic analysis' third element requires the SEC to identify alternative policies that address some or all of the expressed need. In a Proposing Release such as this one, it is normal for the Commission to solicit opinions about possible alternative approaches to solving the basic economic problem. Without a clear expressed need for regulation, however, it is difficult to assess which policies might have similar effects.

25. Finally, an economic analysis should carefully identify the costs and benefits of the proposed regulation and the most plausible alternatives, relative to the underlying baseline scenario. A critical component of any economic analysis is an objective evaluation of the

proposed rule's costs and benefits, both quantifiable and unquantifiable.[34] Even if some costs are not quantifiable, they should be identified so that policymakers can make their decisions using the fullest possible information. Note that those costs and benefits should be measured against a defined baseline, in which the current issues and costs are carefully identified, in order to make an informed decision. In the economic analysis presented in the Proposing Release, the baseline is not well defined, and seems to include conflicting situations, in particular with respect to LP's abilities to fend for themselves in unregulated financial markets.

III. THE ECONOMIC ANALYSIS IN THE PROPOSING RELEASE IS FLAWED

26. As described above, SEC's guidance for evaluating the economic analysis identifies four necessary components that must be addressed in the rulemaking process. After review of the economic analysis in the Proposing Release, I find that the first two components – identifying the problem and the proper baseline – are seriously deficient, which makes it difficult to evaluate the adequacy of the third component – identifying and evaluating reasonable alternatives to the proposed regulatory approach. It is difficult or impossible to identify alternative ways to accomplish some effect if that effect has not been identified. An absence of reliable, alternative policies then makes it impossible to compare their costs and benefits to those of the proposed actions.

27. With respect to the fourth component, it is clear that the economic analysis fails to consider, or even acknowledge, a number of significant costs that would be borne by private fund advisers and investors, should the proposed rules be adopted.[35] Nor does the economic analysis consider the adverse long-term social costs of implementation. As proposed, the rules would reduce capital market efficiency and may well have a significant adverse effect on competition and capital formation, especially among minority and woman-led funds.

28. In the subsections that follow, I first describe how the Proposing Release fails to identify a market failure within the existing regulatory regime: the SEC neither identifies a problem

[34] The SEC Guidance requires that any proposed rulemaking "(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 the cannot be quantified." SEC Guidance, pp. 9–10. The SEC Guidance also advocates for combining the analysis of costs and benefits with the economic effects on Efficient, Competition, and Capital Formation, in order to reduce "redundancy and unnecessary parsing of economic effects." SEC Guidance, p. 14.

[35] The issues with and failures of the economic analyses presented in the proposing release apply to both private equity funds and private credit funds. For ease, I refer to private funds generally, but note that the issues presented in this paper can apply to both types of private funds (equity and credit).

that requires new regulation, nor do they show that the existing regulatory regime is insufficient for addressing those alleged "market failures." I then identify significant categories of costs that are overlooked by the economic analysis, including those that should have been addressed in its cost-benefit analysis and those that should have been considered in its evaluation of efficiency, competition, and capital formation. Lastly, I identify two reasonable alternatives that the SEC failed to consider.

A. The SEC Does Not Identify a Market Failure within the Existing Regulatory Regime

29. A necessary component of SEC rulemaking is the Commission's clear delineation of a market failure that can be corrected solely through regulation. Once a market failure is identified and described, the Commission must conduct a thorough economic analysis that includes a clearly defined baseline.

30. Logically, it is impossible to evaluate a proposal's ability to rectify a problem without clearly specifying what that problem is. The economic analysis in the Proposing Release does not even attempt to address the question of why rulemaking is needed. Rather, the introductory section of the Proposing Release appears to be the only part of the release that attempts to explain the Commission's motivation.[36] That section of the release provides no evidence that there is any market failure, nor that potential abuses in the private fund space are such that they are not adequately addressed by the existing regulatory framework. In other words, not only does the SEC fail to articulate a market failure, but even assuming a market failure exists, the Commission fails to articulate why the current regulatory framework is insufficient for addressing the alleged market failure. Stated plainly, the economic analysis includes a poorly defined baseline that ignores relevant aspects of the current regulatory regime.

31. In the subsections that follow, I first detail how the Proposing Release fails to articulate a market failure necessitating the proposed rulemaking. I then detail how the economic analysis fails to accurately capture the current baseline and therefore fails to show that the current regulatory framework is inadequate for addressing the behavior the SEC alleges to be harmful.

[36] Proposing Release, pp. 7–16.

1. The Economic Analysis Does Not Demonstrate a Problem Requiring New Private Funds Rules

32. The Proposing Release seeks to justify new regulations for private advisers by characterizing the private fund space as one where abuse based on undisclosed conflicts of interest is rampant. The SEC notes that:

> We also have continued to observe instances of advisers acting on conflicts of interest that are not transparent to investors, provide substantial financial benefits to the adviser, and potentially have significant negative impacts on the private fund's returns. [footnote omitted] *These issues are widespread in the private fund context* because, in many cases, the adviser can influence or control the portfolio company and can extract compensation without the knowledge of the fund or its investors.[37]

33. Despite characterizing the behaviors as "widespread," the Commission fails to define, show, or otherwise measure the pervasiveness of such behaviors.[38] The Proposing Release provides no information or evidence about how widespread these perceived problems are, or the extent of investor harm resulting from them, and does not explain why the Commission's existing examination and enforcement authority is not adequate to identify and curtail such activity when it does occur. The Proposal's justification for new regulations are concentrated in the section titled "Background and Need for Reform." This section cites to thirteen enforcement actions occurring between October 2005 and December 2021 to exemplify the sort of abuses motivating the Proposal. This is a rate of less than one example violation annually. Relative to the total SEC enforcement actions filed from 2011–2021 (9,105), thirteen enforcement actions represent a de minimus fraction (0.2%) of the total.[39]

34. Upon review, the cases cited provide weak justification for the Proposal for two reasons. First, the actions have conceptual flaws that preclude their use as justification for the proposed rules, including:

i. The fact that different regulatory regimes applied at the time of the enforcement action than currently exists (the actions predate the significant

---

[37] Proposing Release, pp. 12–13 (emphasis added).

[38] Proposing Release, pp. 12–13.

[39] "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.

regulations recently required by the Dodd-Frank Act and amendments to Form PF).[40]

ii. In twelve of the thirteen cases cited, the Commission failed to obtain an admission of guilt. In each of these cases, the accused neither admitted nor denied the SEC's findings in the enforcement action. That is, the SEC implies fraudulent activity occurred simply because there was a settlement. Yet, a firm might choose to settle an SEC complaint for a variety of reasons other than guilt. The Proposing Release also makes no effort to assess the extent to which the conduct at issue in these enforcement matters should already be covered by the existing regulatory framework. Nor does it provide information about the nature of the investors (LPs) who are allegedly harmed by current private fund practices.

iii. The existence of the enforcement actions themselves implies that an enforcement mechanism already exists and demonstrates that the Commission has tools in place for identifying and taking action when it perceives potentially abusive behavior.

35. Second, the support offered for any one alleged misbehavior is thin – never amounting to more than two cases, some of which have the flaws indicated above. The Proposal's discussion of specific fund misbehaviors is not well documented. For example, their assertion that fund advisers misvalue portfolio companies is supported only by a footnote referencing two settled actions, one in 2005 and the other in 2019.[41]

36. Elsewhere, the Proposing Release attempts to justify the need for rulemaking by making a vague, unsupported claim that "[o]ther conflicts of interest are contrary to the public interest and the protection of investors, and cannot be managed given the lack of governance mechanisms frequent in private funds…."[42] In support of this claim, the release then cites a single, settled enforcement case (involving conduct from 2005 to 2013), in which "the adviser cause[d] one fund to bear more than its pro rata share of expenses related to a portfolio investment."[43] This appears to be the sole justification underlying the

[40] 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 Dodd-Frank Act and amendments to Form PF in 2011.

[41] Proposing Release, p. 14.

[42] Proposing Release, p. 15.

[43] Proposing Release, p. 15.

Commission's Proposal to prohibit private fund advisers from any arrangement where expenses are allocated on anything other than a pro rata basis.

37. In the same paragraph, as another example of a conflict that "cannot be managed", the Proposing Release refers to the common practice of including liability provisions in advisory contracts.[44] The prohibition on liability clauses in proposed rule 211(h)(2)-1(a)(5) is a radical departure from the status quo, and I understand it would place more stringent prohibitions on private advisers than currently exist for advisers of registered investment companies. The totality of the justification given for this extreme Proposal is a footnote to a report from the Division of Examinations stating that liability clauses, depending on the surrounding facts and circumstances, can sometimes be misleading, and the simplistic statement "[w]e 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."[45] This is tantamount to the SEC justifying its proposed rules simply because they deem it to be necessary.

38. The Proposing Release also chronicles settlement agreements following GP actions to re-distribute expenses among a fund's LPs:

> [T]he Commission also has pursued enforcement actions against private fund advisers for practices that have caused private funds to pay more in fees and expenses than they should have, which negatively affected returns for private fund investors, or resulted in investors not being informed of relevant conflicts of interest concerning the private fund adviser and the fund. [footnote omitted] Despite our examination and enforcement efforts, these activities persist.[46]

39. Here again, the Commission supports this claim by citing to a handful of enforcement actions that settled without admissions. Some of these matters apparently concern only inadequate disclosure, with no apparent evidence that investors suffered harm.[47] The existence of enforcement actions does not in itself demonstrate that there is a "problem" that

---

[44] Proposing Release, p. 15.

[45] Proposing Release, p. 15.

[46] Proposing Release, p. 9.

[47] *See*, e.g., In the Matter of Diastole Wealth Management, Inc.; In the Matter of Mitchell J. Friedman; 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.); In the Matter of Monomoy Capital Management, L.P.

must be solved through new rulemaking, particularly if the actions are few in number, are already addressed through the SEC's current authority, and are settled with no admission.

40. Even if the Commission takes the view that settled enforcement actions may be evidence of a need for rulemaking, it should consider the timing of the enforcement actions, and the extent to which other regulatory developments in the intervening years have already addressed the concerns. Some of the enforcement actions cited in the release involve conduct that pre-dates Dodd-Frank rulemaking that significantly increased the SEC's oversight of private advisers and nearly all of the cited enforcement actions involve conduct that predates the Commission's 2019 interpretation on the standards of conduct for investment advisers.[48] These considerations should be enumerated and explained in the baseline analysis of the economic analysis. As I detail in Section III.B., the economic analysis fails to account for these, and other, considerations.

2. The Baseline Presented in the Economic Analysis Fails to Account for the Existing Regulatory Regime

41. Under the SEC's own guidelines, the Commission is required to articulate an appropriate economic baseline against which to measure the impact of their proposed rules. The 2012 DERA guidance establishes that:

> In articulating the appropriate economic baseline for a rulemaking, rulewriting staff should work with the RSFI 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.[49]

42. As part of this baseline analysis, the SEC needs to account for the existing regulatory regime, including a detailed discussion of (i) any relevant regulatory gaps and (ii) why the current regulatory framework is insufficient for protecting investors. The economic analysis presented in the Proposing Release fails to address either of these components of the baseline. Neither the economic analysis nor the Proposal adequately explains why the identified potential problems cannot be rectified by market forces. More importantly, one cannot assess

---

[48] *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.

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

the market's ability to address the alleged problems being addressed by this Proposal without an appropriate definition of the baseline.

i. The SEC fails to identify gaps in the existing regulatory framework

43. In evaluating whether rulemaking is necessary or justified, the economic analysis should recognize prior steps that the Commission has already taken to address perceived concerns. If such previous steps were effective at addressing concerns, evidence that problems existed before such steps were taken is not a good justification for further rulemaking. With respect to regulation of private fund advisors, several prior developments are noteworthy:

i. Rulemaking under Dodd-Frank redefined the Advisers Act to scope in previously unregistered private fund advisers in 2011 (with compliance dates in 2012).[50] Also, new disclosure requirements were required for private fund advisers on Form ADV and on Form PF, with reporting beginning in 2012-2013.

ii. These new requirements brought new private advisers under the examination authority of the Commission. In the years following registration in 2012, OCIE/EXAMS has been examining advisers many of which were newly registered, providing a mechanism for the SEC to identify and address misunderstandings or compliance deficiencies.

iii. In June 2019, the Commission provided new guidance in the form "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" that "reaffirmed" and in some cases "clarified" aspects of the Commission's interpretations.

44. "Risk Alerts" put out by EXAMS staff in 2020 and 2022 helped ensure that private fund advisers understand the SEC's interpretations of their compliance obligations. Presumably, these prior efforts have facilitated ongoing progress in the SEC's effort to protect investors against potential abuses of conflicts of interest by private fund advisers.

---

[50] *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.

ii. The view of accredited investors presented in the Proposing Release contradicts SEC's existing policies

45. As noted above, private funds attract only *accredited investors*. Therefore, the motivation for the proposed rules is, in effect, to protect a group that the Commission itself has routinely determined to be among the most sophisticated and most able to "fend for themselves."[51]

46. In fact, the logic by which a regulation here is required directly contradicts an existing Commission definition of accredited investors. The economic analysis ignores the Commission's 2020 rule extending the definition of accredited advisers. The rule was extended to update and improve the definition of investors that have sufficient knowledge and expertise to participate in investment opportunities that do not have the investor protections provided by registration under the Securities Act of 1933, including rigorous disclosure and procedural requirements. Adopting the present Proposal therefore seems to require a broad reconsideration of the Commission's existing (2020) concept of accredited investors. At the very least, the contradiction between the SEC's prior definitions of accredited investors and the proposed rules begs the question of why investors with "sufficient knowledge and expertise" require these new regulations.

47. The Proposal generally, and the economic analysis specifically, each present a confusing impression of the investors for whom this regulation is being designed. On one hand, the motivation for this regulation presents some or all LPs as easily confused and unable to extract relevant information from the general partner ("GP"). At the same time, the SEC implies that LPs are capable of relatively sophisticated analysis. Specifically, the SEC notes that "[g]iven the cash flows, end investors could compute other performance metrics, such as PME, for themselves"[52] and that "[c]ash flow disclosures for each portfolio investment would enable an investor to construct measures of performance that address the MOIC's inability to capture the timing of cash flows, avoid the IRR's assumptions on reinvestment rates of early cash flow distributions, and avoid the IRR's sensitivity to cash flows early in the life of the

---

[51] Peirce, Hester, "Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking," available at https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922 ("Today's proposal represents a sea change. It embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationships with private funds. Therefore, the Commission judges it wise to divert resources from the protection of retail investors to safeguard these wealthy investors who are represented by sophisticated, experienced investment professionals. I disagree with both assessments; these well-heeled, well-represented investors are able to fend for themselves, and our resources are better spent on retail investor protection. Accordingly, I am voting no on today's proposal."). I note that some limited number of unaccredited investors are allowed in some Reg D deals; unaccredited investors are also allowed in crowd-funding. In both cases, the wisdom of other investors is thought to provide sufficient protection for the unaccredited. These, however, are deals in which all investors get the same terms – unlike a private fund with side pockets.

[52] Proposing Release, p. 269.

pool."[53] The ability to calculate these performance metrics implies a technical sophistication that sets LPs apart from smaller (retail) accredited investors, although there is no basis in law or regulation for such a distinction.

48. Even so, neither the economic analysis nor the Proposal explains why such sophisticated institutions require these new protections. If the baseline investors in private funds cannot fend for themselves, then the definition of accredited investors is inappropriate and must be reconsidered before proposing reforms to private fund contracts and private fund advisers.

49. Moreover, the Proposal seems to conceptualize all LPs as alike. However, the set of potential LPs is so large and disparate that it would be impossible to characterize them all in a homogeneous way. While all of them meet the minimum qualifications of accredited investors, many have further indicators of financial power and sophistication, including holding the qualifications of a Qualified Purchaser.[54] Institutional investors have a range of expertise and sophistications. They also bring various talents to the fund, such as management expertise and contacts for the fund firms. If the baseline (current or status quo) environment includes well-informed, accredited investors who are free to invest in a variety of private funds, as indicated by the definition of accredited investors, why should the SEC interfere with freely-negotiated contracts between knowledgeable parties?

---

[53] Proposing Release, p. 269.

[54] A Qualified Purchaser is defined in 15 USC § 80a-2(a)(51) as follows: "(A) 'Qualified purchaser' means—(i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 80a–3(c)(7) of this title with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission; (ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons; (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments. (B) The Commission may adopt such rules and regulations applicable to the persons and trusts specified in clauses (i) through (iv) of subparagraph (A) as it determines are necessary or appropriate in the public interest or for the protection of investors. (C) The term 'qualified purchaser' does not include a company that, but for the exceptions provided for in paragraph (1) or (7) of section 80a–3(c) of this title , would be an investment company (hereafter in this paragraph referred to as an 'excepted investment company'), unless all beneficial owners of its outstanding securities (other than short-term paper), determined in accordance with section 80a–3(c)(1)(A) of this title , that acquired such securities on or before April 30, 1996 (hereafter in this paragraph referred to as 'pre-amendment beneficial owners'), and all pre-amendment beneficial owners of the outstanding securities (other than short-term paper) of any excepted investment company that, directly or indirectly, owns any outstanding securities of such excepted investment company, have consented to its treatment as a qualified purchaser. Unanimous consent of all trustees, directors, or general partners of a company or trust referred to in clause (ii) or (iii) of subparagraph (A) shall constitute consent for purposes of this subparagraph."

47. Moreover, being able to "fend for themselves" does not mean that accredited investors would equally choose among all available investment opportunities. Part of this sophistication is recognizing investment opportunities that do not fit with their knowledge or expertise. In particular, LP investors are free to choose not to invest in funds whose GPs do not provide sufficient clarity. The presence or absence of information reporting requirements, audits, clawbacks, indemnifications or specific sales practices should be evaluated by any accredited investor before contracting with a private fund.

50. The Proposal is inconsistent in identifying the sort of investment vehicle(s) in which investors need these new protections. The Commission states:

> While some of the investor protection concerns identified herein may relate to an adviser's activities with regard to other client types (e.g., separately managed accounts, pooled vehicles that are not private funds as defined in the Adviser Act), the proposed reforms are designed to address concerns that arise out of the opacity that is prevalent in the private fund structure.[55]

The SEC does not explain why the proposed rules are not applied to these other types of private contracting. Such an explanation could provide valuable information about the SEC's view of who requires protection and why – a major point omitted from the economic analysis.

B. The Economic Analysis Fails to Recognize Some Costs of the Proposed Rules

51. The economic analysis presented in the Proposing Release fails to recognize, let alone quantify, important costs associated with the proposed rules. The costliest elements of the proposed rules coincide with the most draconian measures – namely, the prohibitions on preferential treatment and indemnification. In its own right, prohibiting certain large LPs from negotiating beneficial terms constitutes a significant overlooked cost and may have far-reaching impacts on the investing landscape.

52. The economic analysis also fails to consider important ways in which the proposed rules are likely to affect efficiency, competition, and capital formation. Such restrictions would reduce capital market efficiency because they would restrict the ability of sophisticated market participants to freely negotiate contractual terms that they deem to be mutually beneficial. The private fund market has expanded rapidly because sophisticated market participants have found the existing form of private fund governance to be highly attractive.

[55] Proposing Release, p. 17.

And the Proposal provides little or no evidence that the proposed restrictions are necessary to address a market failure.

53. With respect to competition and capital formation, the proposed new rules will definitely raise funds operating and compliance costs. While larger asset managers may be more equipped to bear the burden imposing new costs, higher operating costs and costs of entry may discourage smaller private fund advisers. Insofar as smaller funds are less able, or even unable to bear such burden, they would become less competitive and may have their viability threatened altogether. The end result could be a chilling effect on capital formation.

54. These negative effects may fall disproportionately on funds operated by minority and women managers, many of whom operate smaller funds with a more limited fundraising process. Without the ability to entice early-stage and anchor LPs through certain preferential treatment, diverse funds may have a significantly harder time raising capital.

55. The Commission failed to account for such adverse, long-term social costs that may occur if the proposed rules are adopted. Taken together, the proposed prohibitions may limit which investors have access to private funds, may challenge the viability of small, minority, and women-led funds, and as a result, change capital market conditions in a way that discourages capital formation in the private fund space.

1. Prohibiting certain large LPs from negotiating beneficial terms constitutes a significant overlooked cost.

56. The contracts and agreements that govern private equity funds—and define the relationship between the adviser and the investors (limited partners)—include some provisions that are general to the entire fund, and other provisions negotiated with individual LPs that are delineated in side agreements. These agreements cover many dimensions of the relationship between the fund advisers and the investor, including for example: (i) the structure and amount of fees, (ii) the type of granularity of information provided about the fund's activities, (iii) the investor's ability to exclude itself from participation exposure to certain fund investments, and (iv) the investor's role in fund governance or oversight.

57. Investors in private equity funds differ from each other in terms of the relative value they place on these dimensions—simply stated, different investors care about different things. Some investors may care about returns and minimizing their fees and little else. Others may place a high value on having timely information about the composition of the portfolio, or on the ability to monitor and conduct due diligence on the advisers. Some of these differences

arise from the fact that the LPs are institutional investors that face different regulatory regimes because they are located in different states or subject to different federal statutes.

58. As a result, fund terms vary among investors, with some larger LPs receiving discounts on certain fees or other "preferential treatment," as noted in the Proposing Release. However, in its assessment of the current investing landscape, the Commission overlooks the fact that larger LPs typically may get better deals for very specific reasons. By contrast, smaller LPs are generally simple passive investors. For example, there are economies of scale associated with having large LPs in a fund: as the cost of onboarding and negotiating with a new investor is spread out over a larger commitment size, the ratio of that cost as a proportion of the commitment typically decreases.

59. Additionally, larger LPs are generally established, reputable institutions that already are, or are likely to become, repeat investors in sponsors' fund products. Larger LPs provide a larger influx of capital as part of a single investor negotiation. Further, agreements in their side letters can often be repurposed for investments in subsequent funds raised by the same GP. This reduces the transaction costs associated with subsequent investments by such LPs. Larger LPs may also have well-known or otherwise enhanced reputations for their investment acumen or their propensity to honor their commitments. The sponsor may also have positive historical interactions with such LPs. This reduces the risk associated with a default by LPs on capital calls for undrawn commitments. As a result of all of the foregoing, larger LPs naturally have some degree of bargaining power during negotiations.

60. Moreover, individual LPs may participate in the fund in ways that add value to the fund and benefit other LPs. For example, an angel investor may provide a large amount of funding early in the process of ramping up a new fund to help ensure the fund gains a critical mass of investment money to launch. This may involve more than simply committing capital to the fund. The angel investors, with more money on the line, have an incentive to perform diligence and monitor the fund advisers, their operations, and governance processes. Other investors may rely on the angel investor's diligence, and on their reputation, as a basis for committing their own capital. More generally, LPs may have unique subject matter expertise and/or a network of connections that they can make available to the fund and benefit fund investors generally. Because these benefits accrue to all fund LPs, the investors who provide those benefits should expect to be compensated.

61. The current regulatory regime allows the fund sponsor to negotiate with each LP individually to customize the fee levels and the terms of the contract along all these dimensions. This allows them to customize the contract in a way that responds to the

investor's needs and preferences, appropriately reflects the costs of meeting the specialized needs of the investor, and recognizes any other benefits the investor may bring to the fund. This heterogeneity also makes it possible to satisfy many investors' concerns within a single fund, which is important if forming funds has fixed costs. For example, if a particular investor brings a large amount of capital to the fund, does not require any customized treatment, and if the investor will help the fund in other ways, the adviser might agree to charge a lower management fee for that investor. If another investor brings a small amount of capital and requires a high degree of specialized treatment that is costly for the adviser to provide, the adviser might be less inclined to offer a lower management fee.

62. While each LP has its own particular requirements with respect to its private fund investments, there are some provision types that are commonly requested by and agreed to among the various investor types. For example, ERISA investors and public plans often request provisions relating to the fiduciary standards applicable to the GP and its affiliates; such provisions are typically driven by statutory requirements. Certain state investors also have provisions that are driven by statutory requirements, such as provisions relating to required reporting or state sovereign immunity. LPs may have required excuse rights (i.e., the ability to opt-out of investments that conflict with religious or moral views) which are commonly driven by their legal, regulatory or policy requirements. Advisory committee seats or special economic arrangements such as reduced management fees or carried interest are commercial provisions that are typically driven by bargaining power, factoring in aspects such as program demand, investor size and whether the investor is, or is likely to become, a repeat investor. Under the proposed rules, it is unclear which, or whether all of these examples would constitute "preferential treatment" necessitating disclosure.

63. The proposed rules could significantly increase the complexity and legal costs of launching a new fund. An adviser worried about compliance might feel it necessary to disclose all the details of every side letter with every LP. Given the large number of ways these agreements can be customized, and the fact that terms can be customized differently for each investor, the proposed new disclosure rules could result in vast, complicated disclosure documents containing an overwhelming amount of information. Moreover, these disclosure documents would need to be modified each time a new investor agreed to invest in the fund with any agreement that could potentially be deemed a form of preferential treatment. Fund sponsors might respond to this increasing complexity by limiting the degree to which they allow investors to customize their agreements. That is, reduced flexibility may result in excluding smaller investors that would require specialized, customized terms.

64. The Proposing Release does not adequately consider the full range of potential costs of this disclosure requirement, which may include not only the legal costs of creating (potentially enormous) disclosure documents, and the cost of due diligence by potential investors to review and extract relevant information from the disclosures, but also the costs of depriving investors of the opportunity to customize contracts in ways they deem beneficial, and the costs to investors if they are excluded from a fund.

65. Lastly, an unintended consequence of the proposed rules for preferential treatment might be that funds will offer less preferential treatment to larger investors, and the larger investors will stop providing the beneficial services they were providing the fund in exchange for this preferential treatment. Another is that fund advisers could find it uneconomic to allow smaller investors, only allow Qualified Institutional Buyers, or may impose substantially higher investment minimums.[56] This would shut out some smaller private fund investors from private funds or at least decrease the set of funds available to them. This is another cost overlooked by the economic analysis.

2. The proposed rules do not consider long-term social costs of implementation.

66. Historically, private funds including hedge funds, private equity/credit funds, and venture capital funds, have had an important role in capital formation, as evidenced by the growth in private funds over the last decade.[57] Not only have they served as conduits for channeling investor funds to finance companies in various stages of development, but they have done so in circumstances where financing through public financing channels may have been difficult. For example, private funds provide financing to startup companies in situations where a high degree of diligence is required to assess the soundness of the business model, and where the success of the company hinges on having investors who take an active role in providing managerial expertise and play a role in corporate governance. For more seasoned companies as well, private funds have acted as activist investors, helping to improve the quality of corporate governance, helping to restructure poorly performing companies, or helping to facilitate a portfolio firm's acquisition or entry to public financial markets.[58] As discussed above, the proposed rules may impose additional costs on private fund advisers, which will likely ultimately be borne by private fund investors. These costs may take the form of prohibitions that force fund advisers to take on more risks, higher compliance costs, new

---

[56] Qualified Institutional Buyers include investors that own and invest $100 million in securities of unaffiliated issuers and be one of several types of entities listed in Rule 144A. *See* 17 CFR § 230.144A.

[57] From 2013 to 2021, the private funds industry in aggregate saw an increase in net asset value (NAV) of over $6.5 trillion. *See* SEC, *Private Funds Statistics*, 2014 Q4, p. 5; SEC, *Private Funds Statistics*, 2021 Q2, p. 5.

[58] Shleifer and Vishny, "A Survey of Corporate Governance", The Journal of Finance 52(2), 1997, pp.737-783.

restrictions that may reduce the efficiency of the investment process, smaller advisers choosing to exit the industry, or advisers restricting access to their funds to some types of investors.

67. Potentially, these costs may result in less investment money being made available to issuers, or investment being directed through other channels. The Proposing Release fails to consider the potential long-term implications of such a shift away from financing through private funds. To the extent that private funds help facilitate capital formation for certain types of issuers in ways that cannot be replicated by other channels, capital formation and efficiency could be significantly harmed in the long run. To the extent less capital is available to private funds that specialize in providing capital to smaller companies, this could also have important implications for small companies.

68. In particular, the prohibitions to preferential treatment put forward in proposed rule 211(h)(2)-3 would likely have a disproportionate effect on diverse funds (those owned by women and racial/ethnic minorities) and may threaten their viability altogether. Specifically, two aspects of diverse funds, each of which affects their ability to raise funds, will become significantly more difficult if the large and early-stage LP investors relied on for fundraising are prohibited from receiving preferential terms.

69. First, diverse funds tend to be smaller. The median size for diverse firms in the private equity market was $100 million in 2021.[59] Although this is considerably higher than the $75 million median size in 2020, it is notably smaller than the median fund size industry-wide, which was $170 million in 2021. Smaller fund sizes result in a more limited fundraising process. In particular, diverse managers often do not meet minimum size parameters required by LPs, including for emerging manager programs. Second, the vast majority of diverse managers raise first time funds. This introduces additional difficulties in the fundraising process. First-time fundraises are reported to be both challenging and time-consuming, particularly for diverse managers.[60] Moreover, these firms may not pursue traditional approaches to fundraising, which could result in these funds going largely unnoticed by larger institutional investors.[61]

70. Additionally, newly formed diverse firms are primarily launching venture capital funds. A Fairview Capital report from 2021 shows that "most woman and minority-owned firms

---

[59] "Woman and Minority-Owned Private Equity and Venture Capital Firms," Fairview Capital, 2021 ("Fairview Capital Diversity Report"), p. 7.

[60] Fairview Capital Diversity Report, p. 6.

[61] Fairview Capital Diversity Report, p. 6.

raising venture capital funds are focused on early stage strategies, often investing at the seed or pre-seed stage."[62] The substantial costs of adopting the proposed rules will disproportionately impact fund advisers with early stage strategies.

71. As a whole, diverse funds represented less than six percent of the total fund count and controlled less than five percent of assets under management (AUM) in the private equity industry in 2017.[63] And while the number of diverse funds has grown each year since, in many ways, the industry as whole still suffers from a lack of diversity. The proposed rules set out by the Commission may reduce, and potentially halt, the gains made by diverse fund managers in the private funds industry. Examples of how changes in business practices or market environment can disproportionately affect diverse funds can be seen in the aftermath of the pandemic. As Fairview Capital reports, the "pandemic disproportionately impacted new and diverse firms since new firms became more difficult for most limited partners to diligence as processes shifted to virtual formats" and "backing new managers was one of the first activities put on pause by limited partners, given the high level of market uncertainty."[64]

C. The SEC Failed to Consider Reasonable Alternatives to the Proposed Disclosure Rules

72. With this Proposal, the Commission has not considered other possible regulations that could achieve the same goals more efficiently, with lower costs, and without creating substantial and unnecessary changes to the private funds marketplace. As discussed above, investors in private funds are sophisticated. Because the majority of investors in private funds are Qualified Purchasers, one possible alternative is for the Commission to restrict the Proposal to affect only private funds with the most vulnerable investors. This would tailor the rule to protect those investors who may be less able to protect their own interests or experience losses (despite being accredited investors). A second alternative is that the Commission could explore whether advisers who meet certain governance or disclosure conditions could be exempt from these rules rather than imposing costly rule changes on all advisers. I note that the Commission appears open to this alternative as they have requested comment on this in the Proposal.[65]

---

[62] Fairview Capital Diversity Report, p. 9.

[63] "Diversifying Investments: A Study of Ownership Diversity in the Asset Management Industry," Knight Foundation, May 2017, available at https://knightfoundation.org/wp-content/uploads/2020/02/Diversity-Report_Executive-Summary.pdf?msclkid=9ec31090c0bd11ec893931921dc5dff7, p. 5.

[64] Fairview Capital Diversity Report, p. 4.

[65] Proposing Release, pp. 323–324.

IV. CONCLUSIONS

73. I conclude that the economic analysis in this Proposal is conceptually flawed and cannot support the Proposal. To start, it does not clearly identify why government regulation of this part of our capital markets is required and why it can make those markets more efficient. The economic analysis also fails to recognize important differences among the investors in a private fund, fails to identify and measure significant costs associated with the proposed rules, and fails to consider the adverse long-term social costs regarding efficiency, competition, and capital formation.