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Vanessa A. Countryman, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-0609

**SEC Release Nos. IA-5955; File No. S7-03-22**

**Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews**

Dear Madam Secretary:

We appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC or Commission) request for comment about its proposed rule, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews* (Proposed Rule). Our comments are limited to certain aspects of the Proposed Rule related to the private fund quarterly statements and the mandatory private fund audit proposals.

**Private Fund Quarterly Statements**

Proposed Rule 211(h)(1)-2 would require a private fund adviser that is registered with the Commission to distribute quarterly statements to its investors detailing private fund performance, fees and expenses. It is not clear whether the Commission or private fund investors may expect the information contained in the quarterly statements to be consistent with the financial information presented under US generally accepted accounting principles (US GAAP) in the annual financial statements prepared by the private fund. Therefore, we have included comments for the Commission to consider when certain information that would be included in the quarterly statements may not align with US GAAP for a variety of reasons. Our comments below highlight potential areas for diversity in practice that may lead to inconsistencies in presentation of the private fund quarterly statements.

*Fees and expenses*

The Proposed Rule would require the quarterly statements to present fees and expenses *paid* by the private fund during the reporting period. We note that the timing of payments for fees and expenses may vary based on the investment adviser's cash management strategies and internal processes for paying invoices, which may result in lack of comparability of reported amounts.

We also note that a cash basis of expense recognition does not align with accrual basis accounting under US GAAP. For example, limiting fees and expenses to amounts paid during the reporting period excludes accrued expenses and loss contingencies, which are recorded in the period when the transactions or events that give rise to such expenses and losses occur. We believe an accrual basis presentation provides a more meaningful representation of the fees and expenses a private fund incurs during the reporting period and the relationship between the fees and expenses and the performance of the private fund.

The Proposed Rule uses the terms *fees* and *expenses* but does not define those terms. We note certain examples of amounts commonly paid by a private fund that generally are not classified as expenses under US GAAP:

- share or unit offering costs paid by certain private funds are charged directly against capital in the statement of changes in partners' capital or net assets<sup>1</sup> rather than recorded as expenses;
- commissions paid when a security is purchased are recognized as a component of the transaction price and recorded as part of the cost basis of the security<sup>2</sup> rather than expensed through the statement of operations;
- foreign withholding taxes are recorded as contra-income<sup>3</sup> rather than presented as expenses.

We recommend that the Commission clarify the nature of the fees and expenses it expects to be included in the quarterly statements and whether such amounts should be reported consistent with US GAAP (or other substantially similar accounting standards used by certain foreign private funds).

#### *Performance measures*

US GAAP requires private funds to disclose financial highlights, which includes performance measures that are similar to the performance measures the Proposed Rule would require to be presented in the quarterly statements (i.e. total return or internal rate of return). However, the US GAAP requirements for these performance measures may differ from the presentation of the performance measures under the Proposed Rule.

For example, the Proposed Rule would require an illiquid fund to present the internal rate of return (IRR) for the private fund taken as a whole, while US GAAP requires a private fund to disclose the IRR when presenting financial highlights for non-managing investor classes only.<sup>4</sup> As a result, carried interest allocations between classes would offset when presented for the fund taken as a whole (as required by the Proposed Rule) and therefore would not be reflected in Net IRR or Net multiple of invested capital (MOIC) (defined in the Proposed Rule). We recommend the Commission consider whether requiring performance metrics calculated for the non-managing investor classes, rather than for the private fund taken as a whole, will achieve the Commission's objectives.

Further, the Proposed Rule would require an illiquid fund to present performance measures for IRR and MOIC, both gross and net of performance-based compensation borne by the private fund. It 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". However, the governing documents of private funds may contain provisions that:

- do not allow allocations of unrealized gains or losses; or
- do not require the recognition of carried interest until a specified date or time, or until the occurrence of a specific event, such as the actual disposition of an investment.

Because the definition of *performance-based compensation* does not specify whether the terms *capital gains* and *capital appreciation* are inclusive of unrealized gains and losses, it is not clear how performance-based compensation would be determined when such contractual provisions exist, and

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<sup>1</sup> FASB Accounting Standards Codification (ASC) paragraph 946-20-25-5

<sup>2</sup> ASC paragraph 946-320-30-1

<sup>3</sup> ASC paragraph 946-830-45-39

<sup>4</sup> ASC paragraph 946-205-50-4

whether the adviser would calculate carried interest consistent with US GAAP<sup>5</sup>. We recommend that the Commission clarify how advisers would determine performance-based compensation for the quarterly statements, and as a component of the Net IRR and Net MOIC performance measures, to avoid potential confusion and diversity in practice.

#### *Consolidated reporting*

The Proposed Rule would require the adviser to consolidate the reporting of the quarterly statements to include substantially similar pools of assets, to the extent such consolidated reporting would provide more meaningful information to the private fund's investors and would not be misleading. It defines *substantially similar pool of assets* to mean "a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons".

Although several private funds managed by the same private fund adviser may have substantially similar investment policies, objectives, or strategies, we understand such funds may have other presentation differences resulting from differences in dates of commencement of operations, differences in expense and fee arrangements, and differences in tax treatment between legal entities, such as withholding taxes in different tax jurisdictions. We bring to the Commission's attention the matter of whether these differences in presentation and operational aspects between funds that would comprise a substantially similar pool of assets would result in consolidated reporting that provides a "more complete and accurate picture" of the fees, expenses, and performance of an individual fund if reported on a stand-alone basis. We recommend the Commission clarify what factors should be considered when determining if consolidated reporting is more meaningful and for assessing whether consolidated reporting would be misleading.

### **Mandatory Private Fund Adviser Audits**

#### *Audit of each private fund*

Proposed Rule 206(4)-10 would require a registered investment adviser to cause each private fund that it advises to undergo a financial statement audit at least annually and upon liquidation. We support the Commission's view that undergoing an audit by an independent public accountant provides enhanced protection to the fund and its investors. Even though an audit expresses an opinion on the financial statements as a whole and not on any individual item, an audit would typically include procedures designed to respond to risks of material misstatement due to fraud such as misappropriation of fund assets and to test the reasonableness of the valuation of fund investments, which may serve as the basis for calculating the adviser's fees.

The Investment Advisers Act of 1940 (the Advisers Act)<sup>6</sup> defines the term *private fund*. The Proposed Rule would leverage this definition by specifying that the mandatory audit requirement applies to *each* private fund that a registered investment adviser advises, directly or indirectly. Some private funds use intermediate or special purpose vehicles when making investments (Investment SPVs) for legal, tax, regulatory or similar purposes that operate in conjunction with, or as an extension of the private fund's investment operations. We recommend the Commission clarify whether such Investment SPVs would

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<sup>5</sup> AICPA Technical Questions and Answers section 6910.29, *Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations*

<sup>6</sup> Section 202(a)(29) of the Advisers Act defines the term *private fund* as an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3) (Investment Company Act), but for section 3(c)(1) or 3(c)(7) of that Act.

be considered a separate private fund as defined under the Advisers Act or whether an Investment SPV receives distinct investment advisory services from the adviser. Absent clarification, determining whether an Investment SPV is subject to the Proposed Rule's mandatory audit requirement may result in diversity in practice in how a private fund adviser determines which entities it would cause to undergo an annual financial statement audit.

*Combined or consolidated financial statements*

The Proposed Rule does not specify whether combined or consolidated financial statements would satisfy the requirement that a registered investment adviser cause each private fund it advises to undergo a financial statement audit annually and upon liquidation.

SEC staff guidance<sup>7</sup> permits an investment adviser to prepare combined financial statements to rely on the audit provision of the Custody Rule when the combined financial statements satisfy certain considerations and would be more meaningful to investors than a stand-alone presentation. Further, certain fund structures may require or elect an accounting policy to present consolidated financial statements in accordance with US GAAP.<sup>8</sup> These scenarios are generally consistent with US GAAP and satisfy the Custody Rule, but it is unclear whether these presentations would satisfy the audit requirement under the Proposed Rule.

We recommend the staff clarify if presentation of combined or consolidated financial statements, when presented in accordance with US GAAP,<sup>9</sup> would satisfy the Commission's objectives under the Proposed Rule. We also recommend that the Commission clarify the circumstances under which it may be acceptable for advisers to prepare combined or consolidated financial statements and still meet the Proposed Rule's audit requirements.

*Financial statement periods*

Regarding the Proposed Rule's requirement for each private fund to undergo a financial statement audit at least annually, there are instances where an initial period of less than one year (i.e. a stub period) occurs due to the timing between a private fund's formation and initial fiscal year-end. Such stub periods are not addressed under the Proposed Rule. Certain private funds may have limited financial transactions or investments as of their initial fiscal year-end reporting date and incur only organizational and offering costs during the initial period. We recommend the Commission clarify the circumstances under which stub period audits are required and the starting date for such stub periods.

In addition, the Proposed Rule would require a private fund to undergo an audit upon liquidation. We observe private funds often continue to obtain annual audits during a prolonged plan of liquidation or wind down period to comply with the Custody Rule. While the Proposed Rule uses the term *upon liquidation*, it does not define that term. We recommend the Commission define *upon liquidation* to support consistent application of practice in satisfying the audit requirements of liquidating entities under the Proposed Rule.

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<sup>7</sup> IM-DCFO 2020-03 (10/23/2020; modified 3/30/2021), *Combined Financial Statements for Compliance with Advisers Act Rule 206(4)-2*

<sup>8</sup> ASC paragraph 946-810-45-2 and IM Guidance Update No. 2014-07, *Guidance Regarding Investment Company Consolidation*

<sup>9</sup> ASC paragraphs 810-10-55-1B and 946-810-45-2

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We appreciate the opportunity to respond to the request for comments on the Proposed Rule. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Michael Hall [REDACTED] or Eric Goldberg [REDACTED] or [REDACTED].

Very truly yours,

*KPMG LLP*

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