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April 25, 2022

VIA ELECTRONIC FILING

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

Re: Request for Comment on Proposed Reforms Regarding Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews; Rel. No. IA-5955; File No. S7-03-22

Dear Ms. Countryman:

Ropes & Gray LLP appreciates the opportunity to provide these comments to the Commission on the above-referenced matter. Our firm represents hundreds of asset management firms that are regulated by the Commission, including those that advise private equity, credit, real estate, and hedge funds, across a wide range of industries and asset classes, certain of which are also investors in other private funds.

The proposed reforms set forth in the Commission's release titled Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release Nos. IA-5955, (Feb. 9, 2022) ("the Proposed Reforms") address certain principles, prohibitions, limitations, and requirements for advisers in carrying out investment advisory business, including limited partnership agreement ("LPA") negotiation and drafting, investor and client reporting, annual audits, liquidity transactions, and fee and expense mechanics. The Proposed Reforms thus would directly apply to our clients. Given this fact, we write to provide our views on aspects of the Proposed Reforms, as practitioners with decades of experience in providing legal counsel to these clients. The comments and opinions expressed herein are not intended to represent individual clients' views, but rather Ropes & Gray's perspective complemented by general input from our clients.

The private funds industry occupies a unique role in the economy by offering alternative investments, which often involve a particular risk profile and distinct structuring methods. For over 40 years, highly sophisticated investors have remained engaged in this industry, despite the potential conflicts and risks that may arise within it, because the benefits these investments offer outweigh those potential conflicts and risks. These investors, which include state pension plans, public pension plans, endowments, sovereign wealth funds, insurance companies, wealthy individuals/family offices, and

funds of funds, have demonstrated their deep understanding of the nuances of these investments through robust contract negotiation and demand for detailed disclosure regarding potential conflicts and risks. In many cases, these investors are themselves fiduciaries and have great incentive to ensure that their contractual arrangements are made on fair terms and protect their constituents' interests.

The Commission's approach to date with regard to this industry has served to facilitate advisers and these highly sophisticated investors' ability to resolve issues through negotiation and disclosure to arrive at the terms they believe to be appropriate given the facts and circumstances surrounding the relevant investments. As recently as 2019, the Commission issued its Interpretation Regarding Standard of Conduct for Investment Advisers (the "2019 Guidance"), which recognized the value of the existing system and preserved this dynamic.[1] Further, in the eleven years since the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") extended regulatory scrutiny to and imposed mandatory registration requirements on most private fund advisers, the Commission has initiated thousands of examinations and a wide variety of enforcement actions in the industry. The industry is thus fully aware of the need to disclose and eliminate conflicts, evidenced by a culture of robust disclosures and proactive LPA negotiations. This approach also accounts for the fact that individual contract terms cannot be evaluated in isolation, without considering reciprocal and offsetting terms.

Despite this history, and the highly sophisticated profile of investors investing in private funds, the Proposed Reforms, on the whole, would represent a significant shift in regulation of this industry. Some aspects of the Proposed Reforms envision practices and prohibitions that are more restrictive than those imposed on advisers that target retail investors, who are generally less sophisticated and empowered than the investors at issue. There is no need to more aggressively regulate highly sophisticated investors that have demonstrated the capacity and resources to negotiate effectively for decades than individuals who, as a general matter, have a more limited knowledge of how the financial system works and are investing significantly less capital than their counterparts in the private funds industry. The Proposed Reforms also, at points, exceed even the highest standards promulgated by the Institutional Limited Partners Association ("ILPA"), an organization that actively advocates on behalf of the investors the Commission aims to protect.

As the Commission explains, it would establish the Proposed Reforms with the authority of Section 211(h) of the Investment Advisers Act of 1940 (the "Advisers Act"), which tasks it with creating rules that prohibit and restrict conduct contrary to the public interest and protection of investors.[2] Relatedly, the Commission's stated goals are to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Yet, in many ways, the Proposed Reforms themselves are contrary to these principles. They will increase burdens on and costs to investors without benefiting them, upset balanced industry practices, and suppress capital formation. Increased cost and risk to

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[1] *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Release No. IA-5248, 2019 WL 3779889, n.31 (June 5, 2019).
[2] *See* 15 U.S.C. § 78o(g).

advisers have the potential to lower returns for investors, as certain advisers will become more hesitant to pursue attractive risk-adjusted investment opportunities. This may limit the number of advisers able to enter the market, thereby giving investors fewer investment options and inhibiting innovative investment strategies. Higher fund setup and operation costs will increase the barriers to entry for smaller advisers in particular, who would be more likely to accept investors with lower subscription minimums but cannot raise enough capital to support such additional costs or absorb the risk of bearing these incremental expenses out-of-pocket without contributions from investors. For example, expanded reporting obligations and requirements that expenses be borne by advisers are a more meaningful burden on firms with lower assets under management. A recent study representing $82.24 trillion in assets under management found that only approximately 1.4% of those assets under management were managed by diverse-owned firms.[3] Any additional barriers to entry for new or smaller advisers, such as the ones described above, are likely to have a significant impact on minority and women-owned firms given these existent challenges.

The Commission should not read Section 211(h) of the Advisers Act to allow it to promulgate the Proposed Reforms in ways that would be harmful to advisers and investors alike and in manners inconsistent with past market and regulatory practice absent specific congressional directive.[4] After all, Congress "does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes."[5] This major shift, both holistically and particularly as to the Proposed Reforms related to liability for adviser misconduct, clawbacks, preferential treatment, certain fee and expense limitations, and adviser-led secondaries transactions, is not in line with the text or spirit of Section 211(h). While Section 211(h) authorizes the Commission's regulation of advisers to private funds, this is not an appropriate extension of that regulatory authority because the Proposed Reforms will hurt investors, not protect them, which is in direct contravention of what this statute authorizes the Commission to do. The most effective way for the Commission to protect the highly sophisticated investors that invest in private funds is to retain its current regulatory regime and allow the industry to continue to develop within this structure.

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[3] *See* https://knightfoundation.org/wp-content/uploads/2021/12/KDAM_Industry_2021.pdf.

[4] The Commission also cites to Section 206(4) as a source of authority, which prohibits advisers from engaging in fraudulent, deceptive, or manipulative practices. Further, the Commission cites to Sections 203(d) and 211(a) as providing authority for its passage of the Proposed Reforms. None of these statutes confer unique rulemaking authority to the Commission, as is the case for Section 211(h). *See* Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,866, 16,974 (proposed Mar. 24, 2022) (to be codified at 17 C.F.R. pt. 275) [hereinafter *Proposing Release*]. We note that Section 203(d) simply states that any act prohibited by the greater chapter applies to "any investment adviser registered pursuant to this section. . . ." 15 U.S.C. § 80b-3(d). Section 211(a) cites to the Commission's authority to issue rules and regulations "as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this subchapter. . . ." 15 U.S.C. § 80b-11(a).

[5] *Whitman v. Am. Trucking Associations*, 531 U.S. 457, 468 (2001); *see also Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, 138 S. Ct. 1061, 1071–72 (2018) ("But Congress does not make 'radical—but entirely implicit—change[s]' through 'technical and conforming amendments.'" (citation omitted)).

Not only do the Proposed Reforms overall represent an unwarranted legislatively unintended and potentially harmful departure from a regulatory regime that has stood the test of time; certain portions of the Proposed Reforms misunderstand or do not account for the way that the private funds industry functions. If the Commission chooses to go forward with these Proposed Reforms, despite the questionable consequences these changes would create, it should, at a minimum, give due consideration to and revise them to account for the greatest challenges and conflicts they create. This would include reconsidering or revising certain rules, providing for grandfathering, and exempting parties. Accordingly, through the remainder of this letter, we discuss our more specific concerns with the Proposed Reforms and suggest ways the Commission could implement them in less harmful ways should it choose to proceed.

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1. The Commission Should Allow for Appropriate Limitation of Liability for Adviser Misconduct

The Proposed Reforms related to the limitation of liability for adviser misconduct (the "Liability Reform") constitute a solution in search of a problem.[6] In this area in particular, the Commission's guidance and regulatory efforts, federal case law precedent, and market dynamics that have followed, particularly since the enactment of Dodd-Frank, have functioned well and have successfully protected investors. Specifically, and most recently, the Commission's 2019 Guidance has been instrumental to advisers and investors in understanding the bounds of Advisers Act fiduciary duties and the manner in which parties can draft contractual provisions shaping the application of such duties.[7] A substantial majority of fund LPAs already prohibit indemnification for bad faith, willful misconduct, and other breaches of the duty of loyalty, as well as for gross negligence. This practice demonstrates that investors already have and effectively exercise appropriate bargaining power to protect their own interests.

The Liability Reform would dramatically change the status quo by imposing a strict liability standard of care on advisers by not allowing advisers to be indemnified for simple negligence. Despite the sea change this would represent, the Commission does not provide examples of investors having been harmed by the current market-based resolutions or standards of care. Nor does the Commission explain how the Liability Reform's passage would prevent the harm it believes is being committed by provisions indemnifying advisers for simple negligence. This justification is necessary, as the Commission states its authorization derives from Section 206(4) of the Advisers Act, which permits the Commission to "define, and prescribe means reasonably designed to prevent" "acts, practices, and courses of business" that are "fraudulent, deceptive, or manipulative."[8] In reality, any potential harm is already being addressed by the current system. Thus, the Liability Reform will not serve the benefit the Commission aims to afford through its passage. Rather, in light of existing extensive guidance, regulation, and judicial precedent, this fundamental change in the standard would result in disruption to the industry and consequent harm to investors. The Commission should retain its current approach and allow these sophisticated parties to continue to delineate the bounds of their fiduciary duties through contract. However, if the Commission chooses to go forward with the Liability Reform, it should take a more balanced approach, which at a minimum would allow a standard of conduct that limits liability for simple negligence.

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[6] *Proposing Release*, *supra* note 4, at 16,925.

[7] *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Release No. IA-5248, n.31 (June 5, 2019). The Proposed Reforms as currently drafted fail to acknowledge that the prior guidance "has engendered serious reliance interests that must be taken into account." *Perez v. Mortgage Bankers Assoc.*, 575 U.S. 92, 106 (2015). "It would be arbitrary and capricious to ignore such matters." *Id.* Should the Commission proceed with rules constituting an extreme departure from previously issued guidance, it should provide further justification for upending the reliance interests placed in the prior guidance, as investors and advisers have relied upon the 2019 guidance and the regulatory and judicial precedent that informed it in the way they negotiate LPAs.

[8] 15 U.S.C. § 80b-6(4).

a. Commission-issued Guidance and Federal Court Precedent Protects Investors' Interests

The Commission and federal courts have for decades vested advisers and investors with the power to negotiate terms that are best suited to their complex relationships and needs because that is the best way to protect these investors. In *SEC v. Capital Gains Research Bureau, Inc.*, the Court held that the anti-fraud provision of Section 206 requires advisers to act in their clients' best interests and to disclose conflicts of interest.[9] However, it acknowledged that common law principles recognized the rights of agents and principals to describe the details of applicable duties through disclosure and contract.[10] Then, in the 2007 Heitman Capital Management No-Action Letter ("Heitman"), the Commission confirmed that "hedge clauses" limiting an adviser's duties under the agreement with the client are not *per se* violations of the anti-fraud provisions of the Act in the case of sophisticated investors and should be judged on a facts and circumstances basis.[11] In Heitman, the Commission declined to take any position "on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law."[12]

Twelve years after Heitman's publication, the Commission drafted its comprehensive 2019 Guidance outlining the specific fiduciary duties it believes advisers have under the Advisers Act—specifically, the duty of care in providing advice that is in the best interest of the client, seeking best execution, and carrying out sufficient monitoring; and the duty of loyalty.[13] The guidance explicitly provided that advisers cannot waive their federal fiduciary duty via contract, thus providing meaningful protection to investors, "regardless of the sophistication of the client."[14] In a footnote to this statement, the Commission helpfully explained that agreements between investors and advisers may "shape" or, in other words, further define and describe the duties and obligations advisers owe to investors within LPAs.[15] The Commission caveated that such clauses would need to be closely analyzed to ensure that they do not violate the Advisers Act's antifraud provisions, and that the sophistication of the client is one key factor to consider.[16] The Commission concluded the footnote by explaining that hedge clauses must be analyzed for comportment with the antifraud provisions as well as the adviser's duty of loyalty.[17] In light of this guidance and prior federal judicial precedent, advisers and their investors have carefully negotiated LPAs to include clauses that further develop and define

[9] *See generally* 375 U.S. 180 (1963).
[10] *Id.*
[11] *Heitman Capital Management, LLC*, SEC No-Action Letter, 2007 WL 789073, at *4 (Feb. 12, 2007).
[12] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Release No. IA-5248, 2019 WL 3779889, n.31 (June 5, 2019).
[13] *See generally id.*
[14] *Id.* at *10–11.
[15] *Id.* at n.31.
[16] *See id.* ("The question of whether a hedge clause violates the Advisers Act's antifraud provisions depends on all of the surrounding facts and circumstances, including the particular circumstances of the client (*e.g.*, sophistication).").
[17] *See id.*

the obligations owed to investors, all the while respecting the fundamental duties owed to clients.

Because of this bedrock principle that fiduciary duties themselves are not waivable by contract, the premise upon which the Liability Reform is based—that advisers would seek or would be able to obtain blanket waivers of fiduciary duties—is inaccurate. In light of the precedent discussed above, such provisions are unheard of in the industry; nor, for that matter, have any investors shown any willingness to accept such blanket waivers. Rather, investors generally insist on contractual statements noting that, except to the extent that duties can be *modified* by contract, as the Commission's 2019 Guidance provided, Advisers Act fiduciary duties apply. When investors and advisers agree to fiduciary duty provisions in LPAs, they do not waive these duties, but instead articulate the details of such duties and the application of them in highly negotiated, lengthy contracts. The market practice is to reflect context-appropriate fiduciary duties within the LPA.

Given the longstanding acknowledgment by the industry and the Commission itself that hedge clauses are permissible for inclusion in LPAs, and parties' use of such clauses responsibly and in ways that render LPAs more tailored to the unique business relationships at hand, the Commission should allow these capable contracting parties to rely on these clauses to establish the clear bounds of their relationships as they have for decades.[18]

b. Investors Knowingly Agree to Standard of Conduct Clauses Because They Allow for the Desired Balance of Risk and Return

Historically, investors have also agreed to these terms knowingly because they recognize the interplay of liability exposure and risk-taking; the latter is a vital and necessary part of investing, particularly in the private funds space. Such negotiation allows advisers to make good-faith investment decisions without fearing baseless or frivolous litigation down the line should an investment underperform. Decades of established fiduciary duty and related law recognize that there are important policy concerns driving the appropriate scope of duties and related protections so that there are appropriately narrow circumstances where a party should be held personally liable for decisions that equity holders might second-guess in hindsight.[19]

While not binding authority, Delaware corporate law is illustrative for analogy purposes. For example, Delaware courts expressly recognize that corporations would struggle to maximize

[18] *See id.*

[19] *See, e.g.*, 6 Del. § 18-1101(b) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."); *Haley v. Talcott*, 864 A.2d 86, 88 (Del. Ch. 2004) ("A principle attraction of the LLC form of entity is the statutory freedom granted to members to shape, by contract, their own approach to common business 'relationship' problems."); *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872, 880 (Del. Ch. 2009) ("Limited liability companies are creatures of contract, and the parties have broad discretion to use an LLC agreement to define the character of the company and the rights and obligations of its members.").

shareholder value when they cannot protect directors and advisers from hindsight claims targeting conduct that was based on a good-faith exercise of their business judgment.[20] Delaware courts and lawmakers simultaneously recognize that corporate shareholders (who are not necessarily sophisticated and do not have the same bargaining power as investors in private funds) need some level of protection. Thus, they have balanced these interests by permitting exculpation and indemnification of directors and officers so long as the operating agreement expressly provides for indemnification, the underlying conduct is indemnifiable pursuant to the agreement, and the implied contractual covenant of good faith and fair dealing has not been breached.[21]

As another example, when shareholders bring private actions against advisers pursuant to Section 10(b) of the Securities Exchange Act of 1934, they must prove intent to defraud, a standard that goes far beyond simple negligence. Without this standard, a defendant could be sued and dragged through costly discovery, motion practice, and even trial any time that investors lose money on an investment. Here too, in the private fund context, it is important for certain guardrails to exist, particularly as to potential liability for simple negligence or good-faith breaches of a standalone fiduciary duty. Without these appropriate limitations, a simple mistake could lead to significant costs—in the form of financial expenses, reputational harm, and distractions from the business. On its face, this outcome would not benefit this industry or the sophisticated investors within it.

Moreover, the threat of such lawsuits will discourage advisers from taking the risks that are necessary to encourage capital formation and will increase costs to investors. Advisers recognize that any increased possibility for litigation will result in the need to shift costs to equity holders in the form of higher insurance premiums and fees in order to protect themselves from severe loss, additional costs, and lower returns and by not taking appropriate

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[20] *See, e.g.*, *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 139 (Del. Ch. 2009) ("Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses.").

[21] Delaware law also offers helpful insight into how the legal landscape has developed alongside the Commission's regulatory efforts. *See, e.g.*, 6 Del. C. § 18-1101(e):

> A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing;

Zimmerman v. Crothall, 62 A.3d 676, 713 (Del. Ch. 2013) ("Whether a party has the ultimate right to an advancement depends on whether his underlying conduct is indemnifiable."); *see also In re ALH Holdings LLC*, 675 F. Supp. 2d 462, 484 (D. Del. 2009) (declining to order indemnification of advisers in connection with successful defense of counterclaim alleging breach of fiduciary duty where the operating agreement contained no indemnification provision).

risks in the first place. Advisers are likely to take other actions to protect against the risk of excessive liability, including putting upward pressure on advisory fees and performance fees to compensate for the increased risk of managing third-party capital. They would, for example, likely delegate a number of functions to push liability out to service providers wherever possible, such as consultants or administrators.

Failing to allow advisers to protect against this risk could also result in anticompetitive trends in the industry. Significantly, the industry could consolidate into larger players with enough assets and other protections against liability. Investment professionals may be less likely to form or join early-stage advisers if one or a few underperforming assets can lead to liabilities for the firm and individual personnel. Additionally, advisers may be less likely to offer investment strategies focused on riskier assets. This would present fewer opportunities for investors and less capital available to less-established ventures, including those that are women- and minority-led. Regulation in this manner is counterproductive to these sophisticated investors, who often invest in private funds for high-risk and high-reward investment opportunities.

This type of regulation will be to the detriment of some investors in particular—*e.g.*, public employee benefit plans—which employ highly sophisticated investment personnel that rely upon riskier investments and are especially affected by increased costs because they suffer from underfunding. State pension plans must meet ambitious return targets to even approximate the possibility of meeting their obligations. Investing well at a compelling risk-adjusted return is difficult, and advisers are needed that evaluate this risk and make complicated judgments based on imperfect information and deploy capital based on their experience, expertise, and a differentiated view of what will generate returns. It is only through these means that public pensions and other sophisticated investors can maintain pace with responsibilities to their stakeholders over time.[22]

c. The Commission Should, at a Minimum, Take a More Balanced Approach to the Liability Reform

If the Commission enacts the Liability Reform, it should take a more balanced approach and clearly delineate its bounds, namely, by omitting simple negligence from the prohibition on seeking reimbursement, indemnification, exculpation, or limitation of liability. Setting aside the obvious constitutional question whether federal rules related to fiduciary duties may

[22] As noted above, because investors cannot sue advisers for damages in federal court alleging Advisers Act fiduciary duty breaches, the Liability Reform would practically only come into play in one of two ways: (1) if the Commission sues the adviser itself or (2) if an investor sues the adviser under state law for breaches of fiduciary duty governed by state law. On the latter, the Commission has previously deferred to the state court system to afford appropriate investor protection where the underlying facts and circumstances require it. The passage of this aspect of the Liability Reform would deprive advisers of important and previously valid defenses in state court, and such interference with state law is not only against previous practice but overreaching.

effectively usurp the states' prerogative to regulate this essential aspect of a contractual relationship, failing to adequately consider alternative approaches to the policy could support future findings that the Commission's rules are arbitrary and capricious.[23]

Any version of the Liability Reform should be limited to prohibiting indemnification and exculpation for duty of loyalty breaches, without affecting negotiating parties' ability to define the scope of the duty of care in a way that comports with federal fiduciary duties (*e.g.*, no indemnification or exculpation for gross negligence) that is almost universally accepted by investors. However, disclosed conflicts should be permitted if they do not cause breaches of the duty of loyalty, in comportment with widespread industry practice. This approach would be less radical and would fully comport with Advisers Act priorities, which focus on adviser conflicts of interest. Further, it would conform with prevailing market practice and other established areas of fiduciary duty law. In the corporate context, *i.e.*, where a private litigant alleges that an adviser breached the fiduciary duty of care owed to the investor, Delaware law requires a showing of gross negligence.[24] Gross negligence is the "reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason.'"[25] Even in the retail-customer space as developed by the Commission, the relevant duty of care standard is gross negligence;[26] holding the most sophisticated and empowered of parties to the same standard should not pose concerns. Reframing the Liability Reform in this way would eliminate the second-guessing of advisers' investment decisions with the benefit of hindsight and address the Commission's concern regarding activities that "harm investors by placing the adviser's interests above those of its private fund clients (and investors in such clients)."[27]

Further, the Liability Reform's prohibition of indemnification and exculpation for "breach of fiduciary duty" reflects a vague standard and should be removed from the final Liability Reform. Maintaining the reference has the potential to be read not to permit any shaping of

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[23] *See Dep't of Homeland Sec. v. Regents of the Univ. of California*, 140 S. Ct. 1891, 1912 (2020).
[24] *See, e.g.*, *Tomczak v. Morton Thiokol, Inc.*, 1990 WL 42607 at *12 (Del. Ch. Apr. 5, 1990).
[25] *Id.*
[26] *See Interpretive Matters Concerning Independent Directors of Investment Companies*, SEC Release No. IC-24083 (Oct. 20, 1999):

> Any indemnification provisions, however, are subject to section 17(h) of the Act. Section 17(h) generally prohibits a fund from including in its organizational documents any provision that protects a director or officer of a fund against any liability to the fund or its shareholders by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of his or her duties as director or officer (collectively, 'disabling conduct'). Section 17(h) is intended to balance the need to ensure that funds have the ability to indemnify directors for liability arising out of actions that they took in good faith with the need for funds and their shareholders to be able to hold fund directors personally accountable for their actions as directors.

[27] *Proposing Release*, *supra* note 4, at 16,866.

the duty by contract and disclosure. Given the analogous state law concepts and general industry practice of shaping duties by contract, the Commission should remove this reference entirely.[28]

2. The Proposed Reforms Regarding Adviser Clawbacks Rely on a Fundamental Misunderstanding of Clawback Mechanics and Would Deprive Advisers and Investors of a Beneficial Way to Appropriately Allocate Risk

The Proposed Reforms related to adviser clawbacks (the "Clawback Reform")—which "would prohibit an adviser from reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders"[29]—set forth a number of limitations on private funds' use of clawback provisions that appear to be at least partially premised on incorrect assumptions about industry practice and applicable tax law.

a. The Clawback Reform Is Based on an Inaccurate Assumption Regarding Clawback Provisions

The Commission's explanation of the Clawback Reform incorrectly suggests that clawback provisions typically reduce "excess" carry (*i.e.*, the amount of carry received in excess of the

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[28] *See* 6 Del. C. § 18-1101(c):

> To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing;

6 Del. C. § 18-1101(e):

> A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

These same principles apply to limited partnerships as well. 6 Del. C. § 17-1101(d), (f); *Sonet v. Timber Co., L.P.*, 722 A.2d 319, 322 (Del. Ch. 1998) ("Delaware's limited partnership jurisprudence begins with the basic premise that, unless limited by the partnership agreement, the general partner has the fiduciary duty to manage the partnership in its interest and in the interests of the limited partners."); *Auriga Capital Corp. v. Gatz Prop., LLC*, 40 A.3d 839, 855 n.65 (Del. Ch. 2012) ("[M]anagers of LLCs owe fiduciary duties because they fit within the classic definition of a fiduciary of a business enterprise under traditional principles of equity.").

[29] *Proposing Release*, *supra* note 4, at 16,977.

amount earned) by taxes due in respect of such excess carry. In practice, the obligation to return excess carry is capped at the excess of the total carry received over the taxes due in respect of such carry. The purpose of this cap is to ensure that carry recipients are not obligated to return more carry than they received and retained after paying taxes on such carry. This type of clawback does not result in any windfall to the adviser.

By way of example, assume the carry recipients receive $100 of carried interest but, due to subsequent fund losses, should have received only $60 of carried interest, resulting in "excess carry" of $40. Assuming an applicable tax rate on such carry is 35%, the retained carry, after paying $35 of taxes, would be $65. A typical clawback provision would obligate the carry recipients to return the full amount of the excess carry (*i.e.*, $40 in this example), provided that such excess carry is less than what the carry recipients retained after taxes (*i.e.*, $65 in this example). The Clawback Reform appears to be premised on the incorrect assumption that carry recipients in this example would be obligated to return only the excess carry less the taxes on the excess (*i.e.*, $26 in this example). In other words, the typical clawback obligation is much more likely to make investors whole than the type of clawback obligation upon which the Clawback Reform appears to be premised, since the taxes are taken into account in the typical clawback arrangement only to the extent necessary to prevent the carry recipients from having to return more than they received and retained after paying taxes.

b. The Clawback Reform Will Force Carry Recipients to Return Gross Tax Distributions in a Manner That Is Unreasonable and Harmful

Advisers and investors typically cap clawback obligations to the amount of carry received net of taxes so that carry recipients are not worse off than they would have been if they had not negotiated for the right to receive carry on fund profits. Private funds with clawbacks have used this approach, almost universally, for decades for that reason.

By contrast, the Clawback Reform would effectively require that performance-based compensation payable in the form of carry be conditioned on the possibility that those potentially entitled to such carry risk bearing taxes attributable to the potential right to such carry whether or not they actually receive and retain carry in excess of such taxes.[30] The rationale for the Clawback Reform appears premised at least in part on incorrect assumptions about the extent to which carry recipients are able to minimize or eliminate taxes on carry (and tax obligations resulting from the right to receive carry even when none is payable), either by structuring how and when carry is payable or by filing amended tax returns to recover taxes on unearned or excess carry.

First, under current tax law, the tax liability attributable to the right to receive carry is determined without regard to when carry is actually distributed. This is because tax law

[30] *See Proposing Release*, *supra* note 4, at 16,923–24.

generally requires private funds taxed as partnerships to allocate their income and gain based on which partners would receive value attributable to such income and gain upon a complete liquidation of the fund whether or not the cash attributable to such income or gain, prior to liquidation, is distributed to the carry recipients or to other partners.

Second, if more income or gain in respect of carry has been allocated or distributed than earned (for example, by reason of subsequent losses), the taxes due on such previously allocated or distributed amounts generally cannot be recovered by amending the tax returns of the years in which such over-allocations or distributions were made. A tax benefit from such subsequent losses can generally be realized only if and to the extent that (a) those subsequent losses can be used to reduce current or future income or gain and thus taxes otherwise owed on such current or future income or gain and (b) such current or future income or gain would have been subject to an applicable marginal tax rate that is no less than the rate applicable to the income or gain recognized in respect of the unearned or excess carry.

For these reasons, the Clawback Reform would likely cause actual losses to carry recipients who are allocated or distributed unearned or excess carry. That is because they would have to pay out of pocket the taxes attributable to such amounts, which are unlikely to be fully recoverable. In no case should the Clawback Reform be adopted absent a change in tax law that would permit carry recipients to avoid recognizing taxable income or gain prior to the actual receipt of carry.

c. The Clawback Reform Will Interfere with Investment Advisory Decision-Making, Causing Further Harm to Investors and Advisers

Prohibiting after-tax clawbacks also interferes with investment advisory decision-making to the detriment of investors on multiple levels. Rules prohibiting after-tax clawbacks could fundamentally change the nature and timing of investment advisory determinations. For example, prohibiting after-tax clawbacks may delay the realization of investments. Further, funds may limit investments with higher risk/return profiles to avoid the types of investment realizations that lead to clawbacks. Investors could thus struggle to find fund investments with a higher risk/return profile to complement more conservative investments in their portfolios.

Clawback arrangements are a prime example of the bespoke economic arrangements that advisers and sophisticated investors need. Where advisers and investors agree on a specific carried interest percentage (e.g., 20%), that agreement is complemented by a commensurately crafted clawback obligation and the corresponding after-tax effects. A higher carried interest percentage is usually accompanied by a more stringent set of circumstances triggering clawback. Conversely, advisers will insist on less stringent clawback triggers unless investors agree that carry recipients need not return more than what they could retain, net of taxes. Mandating pre-tax clawbacks would prejudice this bespoke balancing of interests by either

causing advisers to insist on less stringent clawback triggers or increasing the carried interest percentage required to offset out-of-pocket risk. This skewed dynamic would disproportionately affect newer advisers and, ultimately, investors in their funds, because those advisers have not yet begun to earn carry on vintage funds that would allow carry recipients to mitigate out-of-pocket risk or have established a track record that would allow investors to accept higher carried interest demand and a less stringent clawback trigger.

d. If Enacted, the Clawback Reform Should Not Prohibit Hypothetical Taxes in Clawback Calculations or "American" Waterfalls

The Commission requested comment on potential rules that would (1) prohibit deal-by-deal (i.e., "American-style") waterfalls altogether; and (2) prohibit the hypothetical marginal tax rate to determine the tax reduction amount.[31] We address each request in turn.

First, the Clawback Reform appears to encourage advisers to shift to European-style waterfalls and conservative escrow use to avoid the impacts of clawback provisions in the first place.[32] In that sense, the Commission—through its Clawback Reform—prescribes economic terms for performance fees or carry structures where it lacks authority to do so directly. However, sophisticated parties should have flexibility to negotiate the specific terms of their profit-sharing arrangements.

Additionally, even with a European-style waterfall, a fund will advance amounts to carry recipients to enable such carry recipients to pay taxes to the extent of and in proportion to the carry's income allocations. Otherwise, the carry recipients would receive tax-burdened income allocations without receiving the cash necessary to pay the tax. These tax advances are, in effect, carry distributions by a different name. Thus, the European-style waterfall would not resolve the Commission's concerns, because carry recipients would still receive the carry and use it to make tax payments proportional to their carry allocation (even if the remainder of carry distributions are not made until later). In this way, carry recipients in a European-style waterfall are similarly situated with their American-style counterparts. Therefore, prohibiting an American-style waterfall will not eliminate the practice of receiving clawbacks, net of taxes.

Second, advisers often use hypothetical marginal tax rates, like that of New York City or California, or the highest marginal tax rate of the carry recipient's state, to determine the tax reduction amount in each clawback. Advisers do so for administrative convenience, given the varied tax rates applicable to different carry recipients. If the Commission decides to implement the Clawback Reform with an adjustment to permit after-tax clawbacks, but with

[31] *Proposing Release*, *supra* note 4, at 16,924.
[32] *Id.*

the limitation that such clawbacks are calculated using actual tax rates, significant administrative complexity would result.

If required to use the actual tax rate, an adviser would be tasked with determining each carry recipient's actual effective tax rate, which is no easy task for larger organizations with a diverse and large group of carry recipients (in certain larger organizations, there are sometimes several hundred carry recipients). This also potentially requires carry recipients to send the adviser their tax returns—a new and potentially burdensome obligation that carry recipients may understandably resist. If the Commission continues to permit clawback arrangements on an after-tax basis—as we respectfully request the Commission should—it should allow a hypothetical marginal tax rate as well.

Like any potential reforms prohibiting a hypothetical marginal tax rate, potential reforms prohibiting American-style waterfalls will impose additional administrative burdens that disadvantage investors by disrupting performance fees or existing carry arrangements and it may alter the framework of the existing standard economic arrangement between advisers and investors. For instance, advisers may increase carry percentages, forego offering a preferred return in order to realize carry faster, defer management fees, increase utilization of credit facilities without drawing capital or take other measures to restructure carry terms.

e. Advisers Are Not Stakeholders in Carry Arrangements, Causing Impracticalities

Lastly, as a technical matter, the Clawback Reform would impose the requirements on the adviser—a party that is not a stakeholder in the carry arrangements. Typically, a separate general partner or a carry partner entity is established to receive a carry from a fund. This entity is often a flow-through entity for tax purposes. Carry is then passed upstream to various additional entities and individuals, frequently through complex profit-sharing arrangements. Ordinarily, any deficiency in a clawback repayment would cause a breach of the applicable fund agreement's clawback provision. Then, the fund and/or its investors could pursue remedies outlined in the fund documents. Under the Clawback Reform, an adviser may be liable for a breach of the Advisers Act when a carry recipient fails to contribute its portion of the clawback amount, including taxes. In this case, a breach and any related penalties would not return any financial benefit to investors. If the Clawback Reform is implemented, the Commission should clarify that the requirements apply to the carry recipients, as opposed to the adviser.

3. <u>The Proposed Reforms Related to Preferential Treatment Mischaracterize the Nature of Preferential Rights and, If Adopted, Would Be Harmful to Investors</u>

The Proposed Reforms categorically prohibit certain forms of preferential treatment if the adviser reasonably expects that providing such preferential treatment would have a "material negative effect" on other investors and prohibit certain other preferential terms except where the adviser provides

certain written disclosures to prospective and current investors.[33] In doing so, the Proposed Reforms related to Preferential Treatment (the "Preferential Treatment Reform") mischaracterize preferential terms as inherently harmful and fail to consider the ways preferential treatment drives capital formation and benefits investors. The Commission should not proceed with the Preferential Treatment Reform, or at a minimum should clarify and revise it.

a. Preferential Treatment Is Necessary for Capital Formation and Beneficial for All Investors

Preferential treatment is a necessary ingredient in the capital formation process that cannot be dispensed with without harming capital markets. At the outset of the fund formation process, for instance, providing preferential terms, including in respect of redemption and other key rights, allows advisers to engage larger, strategic anchor investors that are necessary for initiating and sustaining private funds. In fact, many funds are only able to successfully expand their reach to a broader investor base because they are backed by an anchor investor that makes an initial substantial commitment to the fund in exchange for preferential terms, thereby lending credibility and financial support to the fund and enticing smaller investors to follow suit. Restricting or limiting preferential terms in these situations will prevent new advisers and funds, including diverse- and women-led advisers, from gaining momentum in the fundraising process, which will lead to further consolidation and reduction of competition in the industry in favor of large, established advisers.

Even though the practice of granting preferential terms solely to anchor investors or otherwise by reference to investor commitment sizes may initially appear to only benefit the investors receiving such favorable terms, it frequently has the collateral effect of improving the terms for all investors. With respect to liquidity rights, in particular in the open-end fund context, a larger institutional investor may negotiate an individual right that might theoretically have a material negative effect on other investors if exercised; however, that investor may secure that right while also negotiating additional liquidity protections, information rights, and other investor-favorable terms that are ultimately adopted by the fund for the benefit of all investors. In fact, many smaller investors typically rely on larger investors to advocate for more favorable terms for investors as a whole without engaging in their own separate negotiations. Viewed in the broader context of the overall bargaining process between investors and advisers, the negative impact of a given preferential right on other investors may therefore actually be quantitatively less than the negative effect of investors failing to secure ancillary protections as a result of the Commission prohibiting the ability to negotiate that same favorable right in the first instance.

Further, the foregoing argument assumes that a prohibition on any particular type of preferential treatment does not lead to a change in the overall mix of large and small investors

[33] *Proposing Release*, *supra* note 4, at 16,951.

in a given fund. In reality, if the Commission significantly constrains negotiations with critical anchor and larger institutional investors, advisers will be less inclined to accept smaller investors that they must treat on par with substantially larger investors. Smaller investors will therefore either lose significant access to private funds or will need to enter through other access points, such as third-party funds of funds and feeder funds organized to access underlying private equity funds.[34] In each case, the net result is that small investors will be charged an additional layer of advisory fees, performance fees, and/or expenses.

b. Preferential Treatment Meets the Unique Needs of Various Investors' Liquidity Concerns, Regulatory Constraints, or Tax Limitations

The Commission mischaracterizes the practice of granting preferential rights as being primarily for the strategic benefit of the adviser.[35] Rather, advisers typically present baseline terms to the market and it is *investors* that initiate preferential terms to accommodate their individual needs. Whether or not this has a negative impact on other investors is heavily context-dependent. Therefore, constraining preferential terms harms investors that require certain terms as conditions to committing capital to private funds.

With respect to "preferential" redemption rights specifically, these rights in most cases are not granted to curry favor with certain investors or disadvantage others; rather, these rights are granted routinely to account for investors' needs for specific redemption or information rights as a result of a myriad of unique regulatory, statutory, tax or internal policy constraints. For example, many investors require preferential terms in order to allocate capital to private funds while accommodating applicable regulatory frameworks (*e.g.*, the Employee Retirement Income Security Act of 1974 ("ERISA") and the Bank Holding Company Act of 1956), statutory restrictions (*e.g.*, anti-boycott or pay-to-play violations), tax limitations, or internal policies of investors that impose percentage ownership limitations.

By way of example, investors that are insurance companies may require special redemption rights in order to satisfy liquidity tests that are required to be applied across their entire portfolio, and to which other investors are not subject. Similarly, certain public pension plan investors may be prohibited from owning more than a certain percentage of underlying portfolio investments, and therefore will require special redemption rights in order to ensure the ability to remain under their ownership limitations.

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[34] This contradicts the Commission's stated motives when it recently amended the definition of an "accredited investor"—in order to "expand[] investment opportunities while maintaining appropriate investor protections and promoting capital formation." *See* Press Release, United States Securities and Exchange Commission, *SEC Modernizes the Accredited Investor Definition* (Aug. 26, 2020), https://www.sec.gov/news/press-release/2020-191.

[35] *See* Documentation of Registered Investment Adviser Compliance Reviews, Release Nos. IA-5955, 163 (Feb. 9, 2022) ("Side letters generally grant more favorable rights and privileges to certain preferred investors. . . . Advisers often provide these terms for strategic reasons that benefit the adviser.").

In another key context applicable to most private funds, ERISA plan investors usually require special liquidity terms that would be in conflict with the prohibition proposed by the Commission. For example, ERISA plan investors may have redemption rights allowing them to withdraw their fund interests in order to ensure that the fund's investor base does not exceed 25% ERISA plan investors in order to satisfy an exemption from the fund's assets being deemed to constitute plan assets. This redemption right is purely regulatory-driven but would be prohibited on the basis of being theoretically "preferential" to the ERISA plan investors under the Preferential Treatment Reform as currently written, because the ERISA plan investors could experience a favorable return on their investment by comparison to other investors depending on the timing and circumstances of when ERISA plan investors were required to exercise their right to withdraw all or part of their interest in the fund.

If these redemption rights were prohibited, non-ERISA plan investors would still be negatively impacted as well, in particular where a fund needs to incur significant unanticipated expenses to ensure exemption or compliance with ERISA or to terminate and liquidate its investments at an inopportune time and on unfavorable terms to avoid being deemed to hold plan assets.

Further, for hedge funds and other open-end funds in particular, it is standard and common in the market for funds to offer different redemption rights to separate classes or series; for example, one class may pay a higher fee rate in exchange for better liquidity terms and another class may pay a lower fee rate in exchange for more restrictive liquidity rights. The Preferential Treatment Reform, as written, may prohibit classwide "preferential" redemptions even where a whole class—and not just a single investor—receives the favorable redemption terms. If enacted, the Preferential Treatment Reform should not prohibit funds from employing different classwide liquidity terms in order to present a mix of options to investors.

In view of the foregoing, the practice of granting preferential terms is frequently engaged in for the purpose of accommodating unique needs of investors or offering a range of investment options to investors. It is not the case that advisers grant preferential rights primarily for their own benefit, except insofar as the adviser benefits from providing a product that is desirable to investors. In fact, it is frequently the case that investors need to secure these bespoke rights contractually in order to ensure compliance with applicable restrictions, though in practice there is no expectation that the rights will be exercised in the ordinary course. As such, placing prohibitions on special liquidity terms or requiring disclosure of these preferential rights would reduce investment opportunities for investors and create unnecessary expenses for all investors, which in many cases would lead to great harm to investors.

c. Preferential Terms Are Industry-Standard and Reflect Fair Practices in a Complex Negotiation Between Sophisticated Parties

Preferential terms are not only industry-standard—they also comport with traditional notions of fairness. Investors committing larger amounts of capital are often entitled to additional rights compared to smaller investors (*e.g.*, ILPA's model partnership agreements endorse a commitment-based most favored nation ("MFN") provision). In fact, treating two investors the same way when they have made disparate financial commitments may be viewed by many institutional investors to be inherently unfair when they have put more capital at risk than other investors. Additionally, larger investors with substantial commitments may have different liquidity needs simply as a result of the amount of capital they are investing in the relevant fund compared to investors with smaller commitments that have less skin in the game.

These and many other factors come into play in connection with the complex economic and legal negotiations that occur between advisers and highly sophisticated investors in the process of determining the legal terms of a fund and any separate special terms to be granted to specific investors. Removing the flexibility around redemption terms quells freedom of contract to negotiate desired economic terms, to the potential detriment of large and small investors alike. Assuming full disclosure of relevant information, sophisticated investors should have the freedom to determine their own priorities.

d. The Standards Applied to Limit Preferential Treatment in the Preferential Treatment Reform Are Overly Vague

The Preferential Treatment Reform as written lacks a coherent framework for determining which terms are prohibited or require disclosure to other investors. Most critically, the Preferential Treatment Reform's material negative effect standard is indeterminate and not sufficiently clear; as a result, reasonable minds will differ on the parameters of, and analysis under, this standard. This will effectively jeopardize advisers' abilities to engage in many of the very common and commercially desirable arrangements benefiting advisers and investors alike that are outlined in Sections 3.a–3.c *supra*. In the context of specific redemption rights, the Preferential Treatment Reform does not provide advisers with sufficient guidance to make concrete determinations regarding whether a given right would be permissible or prohibited. For example, an anchor investor may have a longer initial lock-up period than other investors, but additional, more favorable liquidity terms after the end of the initial lock-up period. On balance, it may be effectively impossible to determine whether (a) such liquidity terms, taken as a whole, are actually preferential terms, and (b) whether such anchor investor is critical to the fundraise such that, on the whole, granting such rights to the anchor investor does not have material negative effect on other investors. At a minimum, if the Preferential Treatment Reform is promulgated, it should include non-exclusive safe harbor provisions outlining permitted categories of redemption rights.

Further, what constitutes a "substantially similar pool of assets" under the Preferential Treatment Reform is unclear,[36] and the supposed distinction does not protect investors. As formulated, advisers would be required to treat investors similarly when investing in vehicles or accounts side-by-side in the same pool of assets. In effect, the Commission's effort to prevent advisers from working around the restrictions by separating investors into different vehicles would sweep too broadly and end up prohibiting side-by-side investments established for legitimate purposes—not to advantage one investor group over another. For example, under the Preferential Treatment Reform, an investor could not structure a closed-end fund that invests in parallel with an open-end fund (which by definition should have different liquidity terms) if the two vehicles otherwise have similar investment strategies and objectives.

Another common structuring scenario arises where advisers seek to reach a broader investor set by organizing feeder funds, which are then distributed to investors by third parties that may have a broader investor network. The Preferential Treatment Reform would potentially prohibit this structure, which has evolved organically to benefit smaller investors and expand their access to private funds. In this sense, the Preferential Treatment Reform prohibits advisers from offering separate investment products that appeal to a wider set of investors. Instead of fostering access, the reform makes it harder for small investors to participate, essentially giving preferential treatment to large institutional investors.

e. The Preferential Treatment Reform's Approach to Transparency Is Unworkable and Not Aligned with How Private Funds Operate

The Preferential Treatment Reform's transparency requirements are unworkable in practice and would reduce operational efficiency while increasing costs to investors. Under the Preferential Treatment Reform as written, the only ways to comply with these transparency requirements would be to either withhold preferential information from investors that request it or to disclose information to all investors at the same time.[37] Unlike investors in registered funds, investors in private funds are required to meet strict sophistication requirements and frequently conduct detailed diligence on new fund investments. Each investor has its own custom requirements for its diligence process, which can involve a range of unique requests on matters such as the adviser's prior performance, the adviser's compliance policies and practices, applicable market analyses and details on the investment portfolio or pipeline for a given fund. If the Preferential Treatment Reform's transparency requirements were applied to this diligence process, any time an adviser gave new information to one investor in response to custom diligence requests, the adviser would simultaneously need to provide the same information to other investors in real-time, increasing the adviser's operational burdens,

[36] *See Proposing Release*, *supra* note 4, at 16,928.

[37] Where advisers choose the latter, this disclosure requirement would impose an information-sharing concept designed for retail investors in registered investment companies that should not be applied to sophisticated investors.

increasing organizational costs to the relevant fund, and causing information overload for investors that did not desire to receive such information. Even after a fund admits investors, many investors continue to seek additional information, data, and certifications for their own internal compliance and accounting purposes. The proposed mechanics of the Preferential Treatment Reform's transparency requirements would stifle the efficiency of this informal information channel, rendering it difficult for investors to meet their unique information requirements.

Additionally, where an adviser elects to broadly disseminate certain information to all investors to avoid preferential treatment (as opposed to simply withholding information from all investors), the Preferential Treatment Reform's transparency requirements do not flesh out the mechanics for how such information must be shared. For example, the Preferential Treatment Reform does not account for timing dynamics of information-sharing with investors. Over time, an open-end fund that has accepted investors for ten years will have disclosed voluminous details about the portfolio over the life of the fund. If an adviser provides an investor with information about the portfolio in year one, the Preferential Treatment Reform's transparency requirements would theoretically require continual information-sharing to all new investors so that an investor subscribing in year ten suffered no possible disadvantage compared to an investor that subscribed in year one. Such information disclosure would compound over the fund's lifetime, regardless of materiality to other investors. Accordingly, a prohibition on sharing information with one investor but not others, no matter how sensible in the abstract, will be overly burdensome when advisers attempt to apply the rule to real-world fact patterns with minimal incremental benefit, as information becomes less relevant over time.

f. The Preferential Treatment Reform Is Not Aligned with Widely Accepted Market Practice and Would Not Function as Proposed

The proposed disclosure requirements, as written, are not aligned with market practice and expectations. From a mechanical perspective, it will not be possible in many cases to provide an incoming investor with notice of more favorable treatment granted to other investors before the investor makes an investment. For example, leading up to the first closing of a fund, parties will frequently negotiate side letters with investors up to the day of closing. The widely preferred practice is that after the closing (or, more likely, after the final closing) an MFN election process is initiated to distribute notice of various rights that were granted to investors. By necessity, this process is only feasible if it takes place post-closing, or funds would need to pause each closing to distribute notice of the drafts of side letters to other investors and reopen negotiations so that each incoming investor could seek the benefit of rights granted to others.

Where a fund already has contractual MFN mechanics in place, to the extent the Preferential Treatment Reform results in different disclosure requirements, funds would need to run

multiple MFN processes—one to comply with the existing contractual MFN requirements, and one or more to comply with Advisers Act disclosure obligations. Running varying MFN processes at different times would drastically increase the costs borne by investors without a commensurate benefit.

In terms of timing, funds, open-end funds and hedge funds in particular, would theoretically need to notify investors of preferential rights dating back to the fund's inception, even where the investors that received the preferential rights are no longer in the fund. This would make it very difficult for an open-end fund to evolve in line with market norms, as investors will always be able to view the rights granted to prior investors, again with minimal incremental benefits as information becomes stale.

Finally, it is unclear whom the proposed transparency requirements purport to protect. Investors can already negotiate contractual disclosure rights through MFN provisions. However, many choose not to do so due to the added costs of reviewing MFN disclosures or electing additional rights.

g. The Commission Should Clarify and Revise the Preferential Treatment Reform to Benefit and Protect Investors

We offer several alternative solutions to avoid the issues caused by the Preferential Treatment Reform as written that would better align with longstanding market practices in the United States and global private funds markets by enhancing disclosure without imposing unworkable constraints. First, to avoid the above issues for existing funds, at the very least the Preferential Treatment Reform should incorporate a grandfathering provision for previously existing funds and/or a grace period for implementation to preserve preferential rights agreed with investors that are already in place, as further detailed *infra* at Section 8.

Further, the Commission should revise the Preferential Treatment Reform to clarify that (a) customized reporting provisions regularly requested by sophisticated investors and (b) rights of redemption and/or withdrawal provided to investors in both liquid and illiquid private funds via side letter should not be considered to have a material negative effect on other investors in the private fund.

Finally, the Preferred Treatment Rule should be modified to require advance disclosure only of certain specific categories of provisions that advisers may enter into with certain investors via side letter and disclosure of specific provisions to all investors in a private fund following the private fund's final closing (or no more frequently than annually in the case of an open-end fund). This approach would be consistent with the preferential treatment regime applicable to private fund advisers that are subject to the Alternative Investment Fund Managers Directive (2011/61/EU; "AIFMD"). This methodology would also be consistent with the July 2020 ILPA Model Limited Partnership Agreement, which includes an investor-

favorable model MFN provision that contemplates, among other things, that (a) distribution of preferential terms agreed in side letter provisions will occur after the private fund's final subsequent closing and (b) investors will receive full disclosure of all preferential terms but will only be able to elect to receive the benefit of rights granted to other investors at or below their commitment level. In adopting the foregoing approach in lieu of the framework proposed by the Preferred Treatment Rule, the Commission will ensure investors receive full disclosure of the panoply of rights granted to other investors without placing unworkable restrictions on the dynamics that occur between advisers and the sophisticated investors that look to invest in their funds.

4. The Proposed Reforms Would Prohibit Advisers from Charging Certain Fees and Expenses to Clients in Ways that Would Not Serve Investors

As currently written, the Proposed Reforms related to fees and expenses (the "Fee and Expense Reforms") "would prohibit an adviser to a private fund, directly or indirectly, from . . . [c]harging certain fees and expenses to a private fund or portfolio investment."[38] The Fee and Expense Reforms, would, on the whole, interfere with advisers and clients' freedom to negotiate and contract in ways that have served those parties for decades, and create a barrier to entry for new and emerging advisers in contravention of the Commission's mandate and goals. In addition to these issues that would arise from expecting advisers to forgo potential revenue streams and bear fees and expenses more broadly, the proposal exhibits several issues outlined below.

a. Prohibiting Regulatory Expenses and Fees Is Impractical and Harmful to Investors

The Fee and Expense Reforms prohibit an adviser from charging a fund for regulatory and compliance fees.[39] Such prohibition is not necessary as investors already take into account the full fee and expense terms of a private fund investment prior to investing, which are fully disclosed in the offering and governing documents of a fund and are often subject to negotiation among the parties. Any disallowed expenses would inevitably lead to less flexible, and thus in the long run likely less favorable, advisory fee terms for investors (or will be effectively passed through to investors via higher fees). However, if the restriction is adopted, the Commission should clarify that fees and expenses that are technically required of an adviser but concern financial reporting with respect to funds (*e.g.*, Form PF, forms required under AIFMD, CPO Form PQR, and any statements that are ultimately required under the Quarterly Statement Reform) should be specifically allowed. Similar reports with respect to mutual funds are almost universally treated as fund expenses (and are typically handled by fund administrators), and it seems fair and logical to permit effectively the same treatment in the private fund context as well.

[38] *See Proposing Release*, *supra* note 4, at 16,971.
[39] *Id.* at 16,920.

b. Completely Prohibiting Non-Pro Rata Fees and Certain Expense Allocations Would Complicate Deal-Specific Investment Vehicles and Limit Investors' Options

The Fee and Expense Reforms would prohibit an adviser from directly or indirectly charging or allocating fees or expenses with respect to a 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 in such portfolio investment.[40] As an initial matter, the concept of "*pro rata*" in the Fee and Expense Reforms should be more clearly defined such that it would be easier to apply in specific situations. Further, this aspect of the Proposed Reforms fails to consider that in many instances, non-*pro rata* allocations are fair and reasonable to investors.

For example, different funds may invest in various classes or tranches of a portfolio investment's capital structure, or invest in different proportions in the capital structure. Each of these situations would necessitate at least some judgment by the adviser when allocating expenses. In some instances, certain investors and fund vehicles require bespoke structuring due to the investors' tax status, regulatory status, or jurisdiction, in which case it may be fair and reasonable to allocate corresponding expenses in whole or in part to these investors. In these situations, advisers and investors often agree that expenses and taxes related to a blocker—organized to benefit tax-sensitive investors—should only be allocated to investors in *that* blocker. In other instances, it will be appropriate to allocate certain expenses fully to different investment vehicles, such as parallel or feeder vehicles, so that those vehicles bear any incremental expenses specifically related to their operation. For example, the increased cost to audit a non-United States feeder vehicle should not have to be borne by all investors. A rigid *pro rata* allocation formula would force other investors to bear costs better suited to fund investors who require this bespoke structuring.

In addition, it is unclear how the Fee and Expense Reforms would have advisers effectuate *pro rata* allocations at a time when the investment's final ownership is as yet unknown. While advisers in those instances necessarily need to allocate fees and expenses *pro rata* based on the portfolio investment's anticipated ownership, when the final ownership amounts ultimately change, this scenario could result in a non-*pro rata* allocation among investors that is not easily rectified.

The Fee and Expense Reforms' prohibition on non-*pro rata* allocations would also require an unworkable process for deal-specific co-investments, thus hindering market efficiency. If a deal falls through (*i.e.*, a "broken deal"), the co-investors may not yet have executed a commitment to invest a specific amount—or even committed to invest at all. Typically, co-invest agreements will not be finalized until shortly before closing of the underlying asset purchase. The Fee and Expense Reforms would compel the adviser to make arbitrary determinations as to when a co-investor has investigated a transaction sufficiently to bear such

[40] *Proposing Release*, *supra* note 4, at 16,925.

costs. Even if there are formal contractual arrangements in place, those agreements might have specific limitations, requirements, or contingencies for co-investment transactions, and it will not always be clear what an equitable division of expenses for unconsummated transactions would be. For example, a group of investors in one platform will not all get access to the same set of co-investment opportunities, as some investors will be shown certain opportunities and not others, and some investors will be offered a greater share than others in the same co-investment transaction.

We note that the Commission has examined co-investment practices in the past and has declined to extend a *pro rata* expense allocation requirement to deal-specific co-investors. In a 2015 enforcement action, the Commission targeted an adviser's practice of not charging employee co-investment vehicles for certain broken deal expenses, and in that action the Commission specifically declined to extend the requirement that advisers allocate deal expenses to deal-specific co-investors.[41] The same logic should apply with respect to the Fee and Expense Reforms.

The Fee and Expense Reforms could also limit the number of co-investment transactions, which would harm funds and their investors. After all, funds often benefit from co-investors, because co-investors allow the funds to participate in larger transactions or in investment opportunities otherwise unavailable if not for the co-investment. If the Commission implements the Fee and Expense Reforms as written, co-investors may simply refuse to participate in co-investment transactions rather than bear these new expenses. Then, funds may need to pass on a transaction for lack of capital or, in the alternative, expand single investment diversification restrictions or use of bridge financing to obviate their co-investment needs alongside a fund at the time of the investment. This would increase risk exposure to individual investments and could be detrimental to investors. The *pro rata* requirement for fees and expenses should include flexibility for an adviser to use judgment to arrive at different allocations in the interest of fairness. Any regulation in this area would more appropriately take the form of heightened and standardized disclosure, rather than a flat prohibition on non-*pro rata* allocations.

5. Certain Aspects of the Proposed Reforms Related to Quarterly Statements Should Be Reconsidered

Certain aspects of the Proposed Reforms related to quarterly statements (the "Quarterly Statement Reform")—in particular those aspects related to performance disclosure—fail to promote the Commission's stated policy goals of protecting investors and promoting capital formation, because they are misaligned with industry realities, impractical, and/or unduly burdensome, and should be

[41] Kohlberg Kravis Roberts & Co. L.P, Order Instituting Proceedings, https://www.sec.gov/litigation/admin/2015/ia-4131.pdf.

reconsidered by the Commission.[42] At a minimum, should the Commission require the proposed quarterly disclosures as articulated within the Quarterly Statement Reform, it should consider excepting disclosure of *de minimis* offsets, rebates, and waivers, and amend the Quarterly Statement Reform in the ways described below.[43]

a. The Commission Should Abandon the Liquidity-Illiquidity Distinction

In the context of performance disclosure, the Commission should abandon the liquidity-illiquidity distinction, as it is reductive and poses complications for advisers that do not neatly fit into either definition (*e.g.*, open-end real estate funds and permanent capital funds are "liquid" funds as defined, but generally disclose performance with an IRR mechanic). Rather than requiring performance reporting pursuant to the proposed liquid-illiquid distinction, the Commission should afford advisers the discretion to provide the performance metrics that most accurately portray the fund's returns, or at least allow advisers to determine their appropriate categorization.

b. Certain Disclosures' Scope Will Lead to Investors Receiving Inaccurate Information and Create Additional Costs to Investors and Burdens to Advisers with No Real Benefit

In at least two ways—calculating performance measures and disclosing net total returns—the scope of disclosures required for each liquidity category will provide investors with inaccurate information, while overburdening advisers, translating to additional costs to investors.

As the Commission acknowledges, requiring advisers to calculate performance measures for each illiquid fund in particular as if the private fund called investor capital, rather than drawing down on fund-level subscription facilities (for which advisers would have to exclude fees and expenses), would cause net returns for many funds to be higher.[44] Providing investors with

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[42] To provide a sense of scale: for some of our larger clients, complying with the Quarterly Statement Reform on the whole would require as many as five full-time employees for three to four weeks each quarter. The added burden is not justified by the benefit it would provide investors, as investors have historically negotiated custom reporting obligations with advisers. The proposed portfolio investment-level disclosures concerning compensation and ownership would result in the same deficiencies as those described within this section.

[43] The Commission has asked whether it should prescribe a template for the funds table. We would encourage a voluntary template that advisers can use with the allowance to deviate if all information required is included. Many advisers already provide a significant portion of the information required and will need certain flexibility to be able to combine the new required information with the information already provided. However, the existence of a template will serve as a safe harbor.

[44] *See* Documentation of Registered Investment Adviser Compliance Reviews, Release Nos. IA-5955, 70 (Feb. 9, 2022):

> We would generally interpret the phrase computed without the impact of fund-level subscription facilities to require advisers to exclude fees and expenses associated with the subscription facility, such as the interest expense, when calculating net performance figures and preparing the statement of contributions and distributions. This approach would cause the net returns for many funds to be higher than would be the case if such amount were included.

inaccurate hypothetical performance metrics cuts against the purpose of providing the metrics in the first place—to comprehensively understand their existing investments—and requiring a hypothetical net return does not actually communicate to an investor what their experience was. The *actual* returns experienced by investors are affected by both the investments made and the borrowings used to make them. Both are part of the investment process that is measured by performance. Requiring hypothetical returns excluding borrowing would be like requiring an adviser to calculate performance while disregarding any other key component of actual performance of investors. For example, advisers obtain performance returns through, among other things, asset allocation (which sectors to invest in) and security selection (which individual companies in the sector). Following the rationale of requiring hypothetical returns disregarding borrowing, the Commission should require advisers to calculate hypothetical returns assuming that asset allocation was fixed (*e.g.*, all advisers would create hypothetical returns assuming a fixed allocation to each sector), so that investors could see more readily the adviser's individual stock picking skill within each sector and compare that across advisers. The Commission could pick any other component of performance and require advisers to disregard it to create hypothetical returns. Requiring hypothetical performance disregarding borrowing is no different. It is a key component of the investment strategy that generated the *actual* performance enjoyed by investors, and should not be separated out from the other components generating return. An adviser has to decide whether to engage in borrowing, how much borrowing to engage in, how long to keep it outstanding, etc. Some advisers will do this better than others and its effect should be reported to investors (in fact, if investments do not perform well, the borrowing will have caused a further negative drag on returns) so that they know the returns that they actually experienced.

Moreover, requiring illiquid funds to compute performance measures absent the impact of any fund-level subscription facilities is impractical for certain adviser types, *e.g.*, funds of funds, because they may not have access to this information. In addition, we understand from clients that calculation of such hypothetical performance measures is complex, and different advisers might calculate them differently, requiring significant assumptions. This would also make an apples-to-apples comparison difficult. As a result, the Commission should allow funds to compute performance measures accounting for fund-level subscription facilities.

As previewed, the way that net total returns would be disclosed is also unduly cumbersome. Liquid funds would be required to disclose performance based on four variations of net total return, and advisers would be required to disclose the same on an annual basis for each calendar year since the fund's inception, without limitation.[45] The Commission further proposes that advisers show a liquid fund's average annual net total returns over the one-, five-, and ten-calendar year periods.[46] Finally, the Proposed Reforms would require advisers to report performance as cumulative net total return for the current calendar year as

[45] *Proposing Release*, *supra* note 4, at 16,902.
[46] *Id.*

of the end of the most recent calendar quarter, as well as on a quarterly basis for the current year.[47] Importantly, presenting these metrics would inundate investors with information that makes it difficult for them to focus on information that will assist them in understanding their investments, particularly for funds with a lifespan older than 10 years. Indeed, requiring liquid funds to report these periods is inconsistent with the Commission's recent position in the marketing rule, through which it stated that such reporting would not be useful to private funds.[48]

Instead, the Commission should consider requiring the reporting of only (1) average net total returns over the one-, five-, and ten- calendar year periods and (2) cumulative net total return for the current calendar year-to-date and most recent quarter, as those metrics better reflect the performance overview the Commission hopes to afford investors. If the Commission chooses to move forward with requiring all four metrics, it should impose limits on the first metric's relevant period, for example, to ten years, for alignment with one of the other requirements.

c. The Lack of Definition for "Substantially Similar Pools of Assets" Will Cause Confusion Among Investors and Undermine the Commission's Transparency Goals

Because there is no clear definition of "substantially similar pools of assets," the aspect of the rule that requires consolidating such assets is impractical and will cause confusion among investors, rather than lead to the transparency the Commission seeks to provide. This is particularly true with regard to certain fund structures (*e.g.*, where some of the feeders do not invest in some of the masters). The Commission creates room for discretion where doing so would not provide more meaningful information to the funds' investors or would be misleading, but that allowance only causes more opportunities for confusion.

d. The 45-day Timeline Is Overly Burdensome

The Quarterly Statement Reform's 45-day timeline will be difficult if not impossible to meet in certain circumstances. Certain types of advisers, *e.g.*, funds of funds, depend on reports received from underlying funds in order to devise their own reports. Further, where underlying advisers are not SEC-registered, *e.g.*, foreign entities, obtaining the requisite information in advance of such frequent and brief periods will pose compliance difficulties. In the case of Q4 financials, advisers often wait until their annual audit is completed for reporting purposes, which can be as late as March. Performance tends to be volatile and often

[47] *Id.*

[48] Note that the final marketing rule exempts private funds from presenting performance results in advertisements in one-, five-, and ten-year periods. The Commission stated, "we agree [with commenters, including Ropes & Gray] that requiring advisers to provide performance results of private funds over one-, five-, and ten-year periods in advertisements will not provide investors with useful insight into how the advertised portfolio(s) performed during different market or economic conditions." *Investment Adviser Marketing*, Release No. IA-5653, SEC at *182 (Dec. 22, 2020).

changes drastically between the 45-day and the 90-day statement. Releasing performance metrics more frequently would further confuse investors and clients without providing meaningful data.

Where information is not available at the 45-day mark, the Quarterly Statement Reform instructs advisers to rely upon information available as of the relevant date, which potentially entails using prior-quarter data. Providing investors and clients with stale, inconsistent data goes against the interest of improving the quality of information and the ability to better assess and compare their investment. The Commission should allow for reporting within a reasonable time period of at least 60 (but preferably 90) days or reduce the frequency of reporting to a semi-annual basis in order to ease the burden on advisers and minimize likely confusion that will result in inconsistent metrics and data.[49] If the Commission is unwilling to reduce the frequency for all advisers, it should at a minimum do so in the fund of funds context.

e. Distribution of Quarterly Statements Should Be Allowed Via Virtual Access

The Commission's requirement that advisers distribute quarterly statements to all investors individually is unduly burdensome. It should instead allow for distribution of the quarterly statement via access to a virtual data room as part of the definition of "distribute." Such an approach would benefit advisers and investors alike. This is particularly true with regard to funds of funds, where the large number of investors investing in numerous funds complicates the distribution process. As the Commission notes, certain advisers already rely on this approach in distributing information to their investors.[50] In fact, certain investors expect to receive information through this effective and efficient mode of communication. Providing investors with virtual access to reports accomplishes the Commission's goal of providing transparency while, at the same time, eliminating unnecessary costs and challenges.

f. The Commission Should Not Institute Any Prohibitions Based on the Quarterly Statement Reform

The Commission requested comment as to whether certain common private fund fee and expense arrangements should be prohibited, for example, the "2 and 20 model," fees at the fund level above certain maximum fees to be prescribed by rule, compensation from portfolio investments to the extent management fees are also received, performance-based compensation, management fees being charged as a percentage of committed capital, or certain other expense practices or arrangements.[51] A final rule must constitute a "logical

[49] Further, the differing manner in which expenses are accrued, paid, and accounted for across adviser firms will not be easily compared across advisers. For instance, the management company may advance certain expenses and receive reimbursement twice or thrice a year. In this circumstance, quarterly reporting would not be particularly illuminating.
[50] *Proposing Release*, *supra* note 4, at 16,939.
[51] *Id.* at 16,891.

outgrowth" of a proposed rule.[52] A final rule constitutes "logical outgrowth "if interested parties should have anticipated that the change was possible, and thus filed their comments on the subject during the notice-and-comment period."[53] These prohibitions would not constitute a logical outgrowth of a rule related to disclosure alone. Because there has not been a specific proposal on these prohibitions, commenters have not been given a meaningful opportunity to consider them, and particularly here, where such prohibitions would effectively constitute price controls and require economic analysis and study, they should not be instituted.

6. The Proposed Reforms Related to Audits Would Impose Undue Harm on Investors and Cause Impracticalities

The Proposed Reforms related to audits (the "Audit Reform")—which would "require a registered investment adviser providing investment advice, directly or indirectly, to a private fund, to cause that fund to undergo a financial statement audit that meets the terms of the rule at least annually and upon liquidation"—would lead to issues for advisers and investors alike if implemented as drafted.[54] The Commission should allow advisers to comply with the Custody Rule in the alternative, or at a minimum, consider certain adjustments to the Audit Reform.

a. The Hypothetical Benefits of the Audit Reform Are Outweighed by Its Costs

The Audit Reform bears certain similarities to the Custody Rule; however, one notable and problematic distinction is that, under this Proposed Reform, advisers would not be able to rely on the surprise exam under the Custody Rule. Eliminating the possibility of the surprise exam would be particularly problematic for many advisers, such as those that advise hundreds of special purpose vehicles ("SPVs") that are treated as clients. These advisers may create a new SPV for each separately managed account client, may pool client assets into SPVs to make investments, or may create a new SPV for each investment. The costs of completing these numerous audits would be great, and would likely be passed on to investors or borne by the adviser, in which case the adviser's aggregate cost would be materially detrimental to its operations.[55] Similarly, many fund auditors are not independent as defined in the Audit Reform but are independent under other widely accepted independence standards (*e.g.*, AICPA). Eliminating the surprise exam in those cases will have significant costs for investors whose funds are audited by such auditors.[56]

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[52] *CSX Transp., Inc. v. Surface Transp. Bd.*, 584 F.3d 1076, 1079–80 (D.C. Cir. 2009) (citing *Ne. Md. Waste Disposal Auth. v. EPA*, 358 F.3d 936, 952 (D.C. Cir. 2004).
[53] *Id.*
[54] *Proposing Release*, *supra* note 4, at 16,974–75.
[55] By contract, most funds bear audit costs, which is standard industry practice, not just for private funds, but also for commingled funds more generally (*e.g.*, mutual funds).
[56] *See infra* Section 6.b.

The Commission cites no evidence that the surprise exam has been ineffective to date in preventing custody-related issues. The Commission cites only to hypothetical benefits, which are greatly outweighed by the real costs described above.

Similarly, the Commission posits improved valuation as a benefit.[57] However, like custody, the Commission does not refer to a single piece of data suggesting that the valuation benefits resulting from the audit outweigh the significant costs above. For example, in our experience in exams conducted by the Commission staff, (i) unaudited funds are not more likely to have valuation deficiencies than audited funds; and (ii) advisers with separately managed account clients (which are not audited) are not more likely to have valuation concerns than audited funds. In fact, among our clients, the exams with the highest number of valuation deficiencies (primarily coming out of the Commission's San Francisco region) have all related to private funds that were audited in accordance with the "audit exemption" under the custody rule (*i.e.*, under essentially the same standards as are proposed by the Commission in the Audit Reform). Similarly, a brief review of recent valuation enforcement actions against private fund advisers (based on a comparison to their publicly available Forms ADV) suggests that the applicable funds in question were also audited in accordance with the "audit exemption."[58] Clearly, in these cases, both on exam and enforcement, the Commission staff itself did not find the audit to have a material benefit in preventing valuation issues.[59] It is not sufficient for the Commission, in light of clearly demonstrable significant costs, as noted above, to assert a hypothetical benefit without more evidence supporting the benefit (especially in light of the evidence noted above that the benefit may be more limited than asserted by the Commission). As a result, if the Commission decides to move forward with the Audit Reform, it should provide advisers with the option of complying with either the Audit Rule or Custody Rule to ensure that this valuable alternative remains.

b. The Standards for Auditors Would Pose Challenges for Advisers and Investors

Further, the Audit Reform would require that the annual audit be performed by an independent public accountant that meets certain standards of independence and is registered with and subject to regular inspection by the Public Company Accounting Oversights Board ("PCAOB").[60] An adviser's current auditor may meet the AICPA standards of independence but may not meet the standards of independence of Regulation S-X (*e.g.*, the auditor does certain work for a fund portfolio company). Even if the auditor does not meet the Regulation S-X standards, they still may be better equipped to provide services to those funds. For

[57] *See Proposing Release*, *supra* note 4, at 16,911.

[58] *See, e.g.*, EDG Management Company, LLC, Order Instituting Proceedings (Oct. 22, 2020), *available at* https://www.sec.gov/litigation/admin/2020/ia-5617.pdf; Deer Park Road Management Company, LP, and Scott E. Burg, Order Instituting Proceedings (Jun. 4, 2019), *available at* https://www.sec.gov/litigation/admin/2019/ia-5245.pdf.

[59] In fact, in the exams described above, the examiners routinely dismissed the notion that a fund audit should provide them with comfort regarding the adviser's valuations.

[60] *Proposing Release*, *supra* note 4, at 16,911.

example, given the predecessor auditor's experience with the relevant adviser and funds, they will be more knowledgeable of the fund's operations than a new auditor who meets the standards of Regulation S-X. A fund's investors know and trust those auditors based on their track record, and transitioning to an entirely new auditor could be confusing and concerning to these investors (in fact, investors frequently negotiate covenants preventing a change in the auditor). Relatedly, existing portfolio company relationships may limit options for fund auditors that are independent under Regulation S-X, particularly for fund complexes with extensive investment activity, and therefore, many portfolio companies. The most qualified auditors may not meet the independence standards, potentially forcing an adviser to select an auditor that it does not believe satisfies its standards for providing services to the fund, which would not benefit investors. If advisers seek to resolve the independence issue by other means, it could also adversely affect the value of a fund's investments. For example, where an independence issue arises because of the auditor's existing relationship with a portfolio company, as is often the case, an adviser may seek to terminate the auditor's relationship with the portfolio company, even if that is not necessarily most beneficial to its investors.

Further, this aspect of the Audit Reform could increase costs, which ultimately investors will bear. The predecessor auditor may have been chosen based in part on cost considerations. Also, switching auditors could incur additional transition costs for the fund. These additional costs are significant, and out of proportion with the protection they offer investors. While we believe that the Audit Rule should not be required, if the Commission moves forward, it should allow for auditors that meet the professionally recognized AICPA standards of independence to avoid these unnecessary burdens.[61]

c. Audits Should Not Be Required During Liquidation

In addition, the Audit Reform's guidance that audits must be completed during liquidation will impose further costs with limited benefits. Assets tend to be fewer at liquidation given the point in the fund's lifecycle. Audits, particularly under the proposed conditions, are expensive in comparison and would drain a significant portion of the value in the remaining assets. As previously noted, audits are typically paid for by investors, as contracted between the parties. In the interest of protecting investors from the highly unlikely possibility that an adviser steals the minimal assets that remain in liquidation, the Commission would guarantee that investors would never receive such funds, because they would be paid to auditors—an unreasonable result that can be avoided by specifically omitting required audits during liquidation.

[61] We would also urge the Commission to use this opportunity to reconsider the independence standard for accountants under the Custody Rule. The AICPA standard is widely recognized and accepted by private fund investors, and auditor work for a portfolio company (the most common reason in our experience for independence disqualification under Regulation S-X that is still in compliance with AICPA independence standards) is not realistically going to influence the auditor to commit fraud in furtherance of an adviser's Custody Rule violation.

d. Certain Advisers and Clients Should Be Specifically Exempt

In sum, the Commission should consider allowing advisers to determine whether to comply with the Audit Rule or Custody Rule depending on what is appropriate given the facts and circumstances, or, at a minimum, adjust the Audit Reform in light of these issues to better serve advisers and investors. Even if the Audit Reform survives more generally, sub-advisers and collateralized loan obligations ("CLOs") should be exempted from these requirements, as further discussed *infra* at Section 9.

At a minimum, the Audit Reform should specifically exempt funds of funds and CLOs (assuming that they are not exempted more generally) from the suggested timeline of 120 days. The Commission has acknowledged that preparing audited financial statements for some arrangements, such as fund of funds arrangements and CLOs, may require reliance on third parties, which could cause an adviser to fail to meet the 120-day timing requirements for distributing audited financial statements regardless of actions it takes to meet the requirements. As the proposing release noted, the Staff has indicated in the Custody Rule context that they would not recommend enforcement if these funds satisfy the distribution requirement within 180 or 260 days of the fund's fiscal year-end, depending on a variety of circumstances.

7. <u>The Proposed Reform's Requirement to Obtain Fairness Opinions Related to Adviser-Led Secondaries Transactions Is Misaligned with Practical Realities</u>

The Proposed Reforms related to adviser led secondaries transactions (the "Adviser-Led Secondaries Reform") would require advisers to "obtain a fairness opinion in connection with certain adviser-led secondar[ies] 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" the adviser advises.[62] In the context of adviser-led secondaries, advisers are already arranging for fairness opinions where appropriate, despite the Commission's prior lack of regulation on this matter. Providing prescriptive rules around secondaries would thus be contrary to Section 211(h) in that it constitutes a significant expansion of the current obligations on advisers without a need and ultimately to the disadvantage of the industry and investors.[63] Even setting these broader issues aside, there are multiple ways in which the Adviser-Led Secondaries Reform, as currently drafted, is misaligned with realities of practice, and is therefore not feasible and should be revised to limit any harm to investors. Should the Adviser-Led Secondaries Reform be put into place, these aspects of it warrant addressing.

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[62] *Proposing Release*, *supra* note 4, at 16,917.

[63] For comparison, even in so-called "take private" transactions subject to Exchange Act Rule 13e-3, there is no *requirement* to obtain such an opinion, but only a disclosure requirement relating to any such opinion that may have been obtained.

a. Fairness Opinions Are Already Obtained as Appropriate, and a Blanket Requirement Would Be Unwarranted and Harmful

Existing market practices in this area already provide investors significant protections, and an overarching requirement in the form of the Adviser-Led Secondaries Reform would be unnecessary and harmful to investors. Currently, advisers who obtain fairness opinions do so as a matter of best practice, and in connection with fulfilling their fiduciary obligations and satisfying contractual obligations under a fund's LPA. In these cases, an adviser may determine that obtaining a fairness opinion is the best way to fulfill the contractual obligations agreed to with its fund investors along with its existing Advisers Act duties.

Even where fairness opinions may not be obtained, other market practices around adviser-led secondaries transactions already provide significant investor protections while satisfying the adviser's fiduciary duties, thereby obviating the need to mandate them. For instance, adviser-led secondaries transactions often involve a competitive sales process, such as an auction, that determines price independent of an adviser. Moreover, these transactions typically require the consent of the fund investors or a representative board in order to proceed, and such investors will consider the terms of the proposed transaction in determining whether to provide approval. Furthermore, in the context of adviser-led secondaries transactions that involve a continuation vehicle, investors typically have the option either to cash out or to roll their interests into the continuation vehicle. The investors in the divesting fund can therefore vote directly on the terms of any transaction that is presented to them by choosing to cash out or roll.

Notwithstanding the common practice of obtaining fairness opinions, advisers should nevertheless have the discretion to make the determination as to whether to obtain an opinion based on the particular facts and circumstances of the transaction, because there are certain instances in which a fairness opinion is impractical or impossible to obtain, exceedingly costly to investors, of limited utility, and/or not desirable. For example, the price offered in many continuation fund transactions is established by the potential secondaries buyers as opposed to the adviser. Depending on the transaction, price may be established through a traditional auction process or by a third party that is buying a majority of the underlying portfolio investment, where only a stub interest is transferred to the continuation fund. In such cases, a fairness opinion would be of limited utility since the price was effectively established on arm's-length terms by the auction or third-party buyer, similar to where 100% of the asset had been sold with the selling fund potentially retaining a rollover piece. In yet another example, in many funds, investors may not hold interests with equivalent economics if they own different securities, different classes of interests, invest in different tranches or otherwise hold inequivalent interests. In such cases, a fairness opinion in respect of the interest held by one investor would be of limited utility in supporting fairness, from a financial point of view, with respect to the fairness of consideration received by another interest holder, and it may not even be clear as to how the valuation of one interest relates to the value of another interest, in which

case obtaining a fairness opinion based on any such interest could be impractical, if not impossible, not to mention prohibitively expensive.

Correspondingly, compliance with the Adviser-Led Secondaries Reform would be extremely costly; the Commission itself anticipates annual fees for all funds of over $20 million.[64] These are fees that investors would ultimately bear, even in cases where they do not believe that the materials provided would be useful, let alone necessary. These costs would also deter advisers from the use of an efficient liquidity alternative that benefits investors who are looking to cash out of a particular fund, and the corresponding investors who are seeking to invest in such fund. Moreover, as with many of the other Proposed Reforms, the Adviser-Led Secondaries Reform ignores that the parties involved here are sophisticated investors that are completing their own analyses in connection with entering into these transactions. In consideration of the minimal (if any) benefits and high costs, the Adviser-Led Secondaries Reform should not be instituted.[65]

b. The Adviser-Led Secondaries Reform's Focus on Price Is Inconsistent with the Manner in Which Secondaries Transactions Function in Practice

The Adviser-Led Secondaries Reform's focus on price, as opposed to consideration, does not account for the way that these transactions function and will not offer investors the type of protection that the Commission seeks. In the proposing release, the Commission discusses the need to ensure a fair price to prevent conflicts of interest that may arise in these transactions.[66] Thus, it states that the Adviser-Led Secondaries Reform would require advisers to obtain a written opinion stating that the price being offered is fair.[67]

The issue with this approach is that fairness opinions relate to the fairness, from a financial point of view, of consideration (which may differ in certain respects from "price") to be paid or received in a transaction (depending on the party to whom the opinion is rendered). In essence, a fairness opinion relates to a has-gets analysis, in consideration of what the buyer or seller is giving up and getting in return (or vice versa). In this context, fairness is understood to depend on whether the consideration falls within a range of values implied by financial

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[64] *See Proposing Release*, *supra* note 4, at 16,954. In reality, the costs to the industry would be astronomically higher. A single fairness opinion can routinely cost several hundred thousand dollars and, in certain instances, more than a million dollars.

[65] The Commission has requested comment on whether the scope of fairness opinions should be expanded to cover all or certain terms of the transaction; it should not for all of the reasons discussed. The Adviser-Led Secondaries Reform inappropriately undermines investors' freedom to contract, and expanding it would be even more detrimental. Moreover, fairness opinion providers explicitly exclude from the scope of their opinions anything other than the fairness, from a financial point of view, of the consideration exchanged in the applicable transaction. Therefore, it is unclear that a market would be available for opinion providers to opine on any terms other than consideration to be paid or received in the transaction.

[66] *See Proposing Release*, *supra* note 4, at 16,917.

[67] *Id.*

analyses relating to the assets subject to the transaction. When the consideration to be paid is not exclusively cash, these analyses are often performed with respect to both the assets being sold and the consideration being paid. Accordingly, any rule that may be adopted should refer to "consideration" rather than "price" and should provide flexibility to reflect the actual "direction" of the transaction.

c. The Adviser-Led Secondaries Reform Includes an Overbroad Definition of Adviser-led Transactions

The Adviser-Led Secondaries Reform would apply to transactions "initiated" by the adviser, which is not the appropriate construct. Although ultimately noting that secondaries transactions are often highly bespoke and can take many forms, leading to the need for a facts-and-circumstances analysis, the Commission believes that a transaction is initiated by the adviser if the adviser commences or causes another person to commence a process to offer liquidity to private fund investors.[68]

However, this definition may inadvertently pick up certain types of routine cross-trades that are consummated on pre-agreed terms (*e.g.*, at cost plus interest) and should not require a fairness opinion. This can occur, for instance, in a so-called "season-and-sell" strategy where one fund holds a debt instrument for a period of time prior to transferring a portion to another fund vehicle, in connection with rebalancing between parallel funds or where one fund provides a "warehouse" for another fund. There are many other types of transactions that should be excluded from the definition:

- If a buyer or seller of a fund interest had expressed an interest to the adviser in participating in a transaction at one point, and the adviser subsequently attempts to find a client who would like to purchase the interest (or vice versa), has the adviser "initiated" a transaction?
- For some funds, there may be an automatic process required by the fund documents for the adviser to annually (or at some other period) reach out to buyers and/or sellers to inquire if there is any interest in engaging in a secondaries transaction. Would an adviser be deemed to have "initiated" a transaction in this instance?
- How is a secondaries transaction different from an open-end fund of funds that offers liquidity (since that liquidity is frequently dependent on finding subscriptions into the fund of funds to "buy out" the redeeming investor)?
- In many instances, while the initiation of a secondaries sale by the adviser may be unsolicited, the buyer or seller may have expressed an interest in such a transaction at

[68] *Id.* at 16,918.

some point. How recently should the buyer and seller have expressed this interest for it not to constitute adviser-led secondaries?

- In many instances, a fund will enter into a transaction with the intention of selling down a portion to co-investors promptly after closing. In certain cases, an affiliate of the adviser will be managing the vehicle through which co-investors participate. This mechanic benefits the fund and its investors because timing may not have permitted the co-investment syndication prior to closing. Would an adviser be deemed to have "initiated" a transaction in this instance?

We believe each of the foregoing examples should be clearly excluded from the scope of the reforms through rule or guidance.

The Adviser-Led Secondaries Reform would also pick up transactions where investors are offered the opportunity to sell to a bona fide third party (*e.g.*, in adviser-led tender offers) and are not required to sell. In that case, the pricing can be presumed to be on arm's-length terms and not susceptible to manipulation for the adviser's benefit. Further, clean-up trades below a *de minimis* threshold should be exempted from this rule, as they are done as a matter of course and do not pose the same underlying concerns in respect of conflicts of interest as traditional secondaries transactions. The Commission should instead allow advisers to review such transactions on a transaction-by-transaction basis and determine if any conflicts of interest exist and that they are appropriately addressed.

d. The Adviser-Led Secondaries Reform's Timing for Distribution of Fairness Opinions Is Problematic

The Adviser-Led Secondaries Reform requires distribution of the opinion to all investors prior to the closing of the transaction. In practice, however, this timing does not work.

Fairness opinions are generally rendered to a fiduciary (*i.e.*, a board or a general partner of a fund) at the time the fiduciary is making a decision. For example, in connection with the sale of a public company, the opinion would be addressed to the board of directors (or a special committee) of the "target company" and generally address whether the consideration to be received by the target shareholders is fair to such shareholders from a financial point of view (the opinion is not addressed to the target shareholders). In some cases, the board of the acquiring company will also obtain an opinion as to the fairness, from a financial point of view, to the acquiring company of the consideration being paid by the acquiring company in the transaction. In contrast, in the example of a traditional secondaries transactions market in the context of a private fund, fairness opinions are sometimes obtained at an earlier stage of a transaction in order to provide the fund's advisory board information to make a determination as to whether to waive conflicts and allow a conflict transaction to proceed. In this case, any proposed rule or guidance should make clear that this opinion is the opinion that would be

circulated to investors unless there has been a material change in the terms of the transaction since the delivery of the opinion.[69]

e. The Definition of Who Qualifies as an Independent Opinion Provider Should Be Revised

The Commission should reconsider the proposed definition of who qualifies as an independent opinion provider. Currently, the proposed definition of "independent opinion provider" requires that the provider offer "fairness opinions" in the ordinary course.[70] The term "fairness opinion" is limited to opinions relating to secondaries transactions as opposed to the broader category of fairness opinions.[71] This may render many qualified fairness opinion providers ineligible to provide fairness opinions in secondaries transactions.

Additionally, requiring advisers to provide a summary of material business relationships with the fairness opinion provider is unnecessary as advisers are already subject to a fiduciary duty to disclose any material conflicts to their investors. Any material business relationships with fairness opinion providers that give rise to material conflicts of interest would require that information detailing such conflicts be disclosed to existing and prospective new investors. Any version of the Adviser-Led Secondaries Reform should reconsider these elements of the requirement related to independent opinion providers.

8. <u>The Commission Should Include Appropriate Grandfathering Provisions in the Proposed Reforms</u>

Because the Proposed Reforms as written do not include any grandfathering provisions related to current practices, they would retroactively nullify longstanding industry norms and disrupt multitudes of bargained-for contracts between consenting parties on key issues such as payments, agreements for preferential treatment, fees, and legal liability. Specifically, they prohibit the collection of certain fees, payments, and agreements regarding liability (*e.g.*, indemnification and exculpation) in already bargained-for contracts among highly sophisticated consenting parties. Indeed, this approach undermines well-established law disfavoring rules that have a retroactive effect based on considerations of fair notice, reasonable reliance, and settled expectations. As the Supreme Court has stated, "[t]he presumption against retroactive legislation is deeply rooted in our jurisprudence and embodies a legal doctrine centuries older than our Republic."[72] This principle is rooted in "familiar considerations of fair notice, reasonable reliance, and settled expectations," and so that individuals can "know what the law is" and "conform their conduct accordingly."[73] This presumption applies to

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[69] As with quarterly statements as discussed *supra* Section 5.e, if fairness opinions will be required to be distributed to all investors, it should be clarified that this can be done by providing access to a virtual data room with a click-through acknowledgement of confidentiality and non-reliance.
[70] *See Proposing Release*, *supra* note 4, at 16,975.
[71] *Id.*
[72] *Landgraf v. USI Film Prod.*, 511 U.S. 244, 265 (1994).
[73] *Id*. at 265, 270.

administrative rules, which may not be applied retroactively unless "their language requires this result" and "the power to promulgate retroactive rules is conveyed by Congress in express terms."[74] This principle is also rooted in statutory law. The Administrative Procedure Act explicitly defines a "rule" as having a "future effect."[75] Accordingly, any rule with retroactive implications must be carefully tailored and contain clear statutory language allowing, and justifying, such an effect.

The Proposed Reforms have an undeniable retroactive effect by altering the scope of lawful activities on previously bargained-for legal agreements throughout the private funds industry. They also change the legal landscape by taking and impairing vested rights acquired under existing law and attaching new disabilities to transactions and legal events that have already passed.[76] Retroactively regulating carefully negotiated contracts, largely involving transactions and events that have already occurred, will cause inequities and practical complications.[77] Dodd-Frank did not authorize retroactive laws, let alone retroactive regulations, nor did it provide any justification for retroactively regulating the prohibited activities.[78] For this very reason, previous attempts by the Commission to retroactively regulate conduct under Dodd-Frank have been unsuccessful.[79]

Moreover, while many of the contracts at issue are still effective, the key transactions and legal events have already occurred. In other words, the parties have already agreed to the terms by which they will be governed. Upending those terms would cause inequities and practical complications that the Commission should avoid through appropriate grandfathering provisions. Specifically, advisers may have offered different terms or even chosen not to raise a fund if they had been aware of some of the implications of the Proposed Reforms. The key factor is whether the agreement has been executed, not whether the agreement is still in effect;[80] the presumption against retroactivity for preexisting

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[74] *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988).

[75] 5 U.S.C. § 551(4).

[76] *See, e.g.*, *Marrie v. S.E.C.*, 374 F.3d 1196, 1207–08 (D.C. Cir. 2004) (noting the Commission "changed the legal landscape [by] applying" an amended definition regarding professional conduct); *Bartko v. Sec. & Exch. Comm'n*, 845 F.3d 1217, 1224 (D.C. Cir. 2017) ("The application of post-Dodd-Frank penalties to pre-Dodd-Frank misconduct constitutes a quintessential example of 'attach[ing] new legal consequences to events completed before [Dodd-Frank's] enactment.'" (citation omitted)).

[77] *E.g.*, advisers may have offered different terms or even chosen not to raise a fund if they had been aware of some of the implications of the Proposed Reforms.

[78] *See, e.g.*, *Henning v. Wachovia Mortg., FSB*, 969 F. Supp. 2d 135, 146 (D. Mass. 2013) ("Courts have uniformly held, however, that the provisions of Dodd-Frank are not retroactive"); *Koch v. S.E.C.*, 793 F.3d 147, 158 (D.C. Cir. 2015) (observing "the Dodd-Frank Act does not expressly authorize retroactive application"); *Bowen*, 488 U.S. at 208.

[79] *See, e.g.*, *Koch*, 793 F.3d at 158 (barring the Commission's attempt to retroactively bar an adviser from "associating with municipal advisors and rating organizations" under Dodd-Frank); *Bartko*, 845 F.3d at 1224 (barring the Commission's attempt to retroactively bar a broker-dealer from associating with the "investment advisor, municipal securities dealer and transfer agent classes").

[80] In an analogous situation, the Ninth Circuit found that a federal law "would have an impermissible retroactive effect if it conferred standing to bring claims for damages on the basis of contracts executed before the [law]'s effective date." *Rivas v. Rail Delivery Serv., Inc.*, 423 F.3d 1079, 1084 (9th Cir. 2005). Importantly, the court noted "there is no evidence that Congress intended for the [law] to apply to [earlier] contracts," and therefore determined the law applied only to "contracts executed after its enactment." *Id.* at 1084–85. Similarly, the U.S. Court of Claims found that a regulation was

agreements "is particularly true of directives dealing with the substantive aspects of contracts; it would be a rare regulation which would even seek to modify . . . substantive rights in an agreement already consummated."[81] The Proposed Reforms should therefore only apply prospectively to future contracts and agreements; taking away these rights *ex post facto* is not appropriate. Through the inclusion of grandfathering provisions, the Commission could accomplish its goals while minimizing disruption in the private funds industry and the investment community at large, honor the reasonable reliance interests and settled expectations of consenting parties, and respect longstanding precedent disfavoring retroactivity.

9. The Commission Should Clarify That Certain Advisers or Clients Are Expressly Excluded from the Proposed Reforms

While the Proposed Reforms are problematic from a policy perspective and as a practical matter in certain ways for all advisers and their clients, as described throughout this letter, it would be particularly inappropriate to implement them as to some advisers, including sub-advisers and those that are unregistered, and with respect to certain clients, including funds of one, CLOs, and non-fee-paying clients. Further, the Proposed Reforms should not be extended to clients that are not technically "private funds" but that are included as private funds in Advisers Act filings.

a. The Proposed Reforms Should Not Apply to Sub-advisers

Sub-advisers should be exempt from the Proposed Reforms because sub-advisers practically do not have the power or information necessary to comply with them and as a matter of policy. Where both adviser and sub-adviser of a private fund are registered, investors in the sub-advised private funds would still receive any protections by virtue of the adviser's compliance. However, in certain cases, the adviser will not be registered, for example, in the case of a non-United States adviser to a private fund using a United States registered sub-adviser. In such situations, the sub-adviser does not have the power to ensure compliance with any of the Proposed Reforms. For example, the sub-adviser cannot force an audit or the distribution of a quarterly statement (and would not have access to the information necessary to comply with the Proposed Reforms in any event).

The Audit Reform in particular includes the requirement that sub-advisers take "reasonable steps" to cause an adviser to implement an audit. A question remains as to whether a sub-adviser can continue with an engagement if the adviser fails to get a client fund to implement an annual audit after taking reasonable steps. Retaining such a requirement would cause unregistered advisers to make the choice of complying with a requirement that they are not otherwise subject to or choosing not to hire registered sub-advisers. Moreover, it is unclear

"irrelevant" because, among other reasons, the contract was "entered into" before the time of the regulation. *Lockheed Aircraft Corp. v. United States*, 426 F.2d 322, 327–28 (Ct. Cl. 1970) (also noting that the "normal rule is for . . . regulations to be applied prospectively to events and agreements which occur later" (emphasis added)).

[81] *Id.* at 328.

whether the obligation would be ongoing, even after the initial engagement, in perpetuity. The sub-adviser typically is not a party to a fund agreement and is not contractually responsible for preparing fund reports. Instead, the adviser is engaged by the general partner and fund through an investment management agreement. Thus, a question remains on whether a sub-adviser is prohibited from advising a private fund if the contractual documents do not provide for audited reports, or if the general partner fails to cause an annual audit to occur even if the fund agreement calls for one (or fails to, for example, distribute the required quarterly statement). In other words, there will rarely be contractual privity for a sub-adviser to enforce reporting by the fund/general partner and its administrator. In most sub-adviser arrangements, the negotiating leverage belongs with the adviser, and the sub-adviser's ability to force change is limited.

Aside from the practical issues discussed above, the existence of a registered sub-adviser should not change the Commission's and Congress's long-standing positions that certain investors (investors in funds managed by non-United States advisers, venture capital advisers, real estate advisers, etc.) do not receive certain protections because advisers to the funds in which they invest are not registered. The presence of a registered sub-adviser should not change such positions (or force the unregistered adviser not to hire registered sub-advisers).

b. Unregistered Advisers Should Be Excluded from the Proposed Reforms

Unregistered advisers should likewise be excluded from the Proposed Reforms. Their inclusion is an overreach for provisions of the rule related to prohibited practices to apply to advisers that are not registered with the SEC, including non-United States advisers, venture capital fund advisers, and other exempt-reporting advisers. As noted above, this would be inconsistent with congressional intent and longstanding Commission positions.

c. The Proposed Reforms Should Not Apply to Funds of One

The Commission has traditionally treated funds of one as separately managed accounts as opposed to private funds for other purposes, and funds of one should similarly be out of scope for purposes of the Proposed Reforms.[82] It is reasonable to treat them as separately managed accounts for these purposes as well; they do not have the same risk profile and conflicts as commingled private funds. Further, including fund of ones would encourage advisers to structure these clients as separately managed accounts, which would result in the loss of tax

[82] *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Adviser Act Release No. 3222 at 78-79 (June 22, 2011), *available at* https://www.sec.gov/rules/final/2011/ia-3222.pdf (stating that funds "tantamount to separately managed accounts" should not be treated as "private funds"); *see also* Form ADV and IARD Frequently Asked Questions, *available at* https://www.sec.gov/divisions/investment/iard/iardfaq.shtml (Form ADV: Item 5.D: "[A]n adviser generally should not consider a single-investor fund to be a pooled investment vehicle if that entity in fact operates as a means for the adviser to provide individualized investment advice directly to the investor in the fund.").

advantages for investors and structures that make advisers' co-investing desired by the client easier. The loss of this flexibility and these advantages would hurt investors.

d. CLOs Should Be Excluded from the Proposed Reforms

While as a technical matter, CLOs are private funds, their structure and purpose are sufficiently distinct from other types of funds that their advisers should be exempt from the Proposed Reforms with regard to them. CLOs are unlike private funds in several ways, including (i) most notably, CLOs do not issue equity but rather issue notes at various seniorities that entitle holders to interest payments and ultimate repayment of debt;[83] (ii) CLOs do not have general partners affiliated with their advisers but rather have unaffiliated trustees as fiduciary agents of CLOs' investors; and (iii) their notes are regularly traded such that at any given time, an adviser does not necessarily know who the noteholders are. As a result, the application of the Proposed Reforms has little or no value and/or it would be impossible to comply. For example, with regard to quarterly reporting, an adviser does not have certain aspects of the reporting information necessary to either compile the reporting information or distributing it to investors would present difficulties.

Similarly, regarding the Audit Reform, most CLOs do not have custody over client assets but instead rely on the authorized trading exemption under the Custody Rule. They also rely on trustees as fiduciary agents for the CLOs' investors and to hold CLOs' assets, a role that is analogous to both general partners and custodians of private funds. As such, only trustees have possession of and the authority to obtain possession of CLOs' assets. Valuation is a less important concept in CLOs because noteholders do not hold a *pro rata* slice of assets and are simply entitled to repayment of debt. Requiring CLOs to comply with the Proposed Reforms would fundamentally alter the CLO market and impose onerous and burdensome requirements on advisers and CLO investors (who would ultimately bear these expenses) where the structure of CLOs and duties of the trustees adequately address the Commission's concerns. The reasonable approach would be to exempt advisers from complying with the Proposed Reforms as to CLOs.

e. Non-Fee-Paying Clients Should Be Exempt from the Proposed Reforms

Non-fee-paying clients should be excluded from the Proposed Reforms. These generally include proprietary, employee, and friends-and-family vehicles for which the adviser is not compensated for its services. The Proposed Reforms will lead to significant, and in certain cases prohibitive, costs and risks to advisers with such clients (who, by definition, are not paid

[83] We note that there is common equity issued by a CLO with a *de minimis* value (e.g., $250 when the CLO is dissolved), and that the most junior tranche of notes can have equity-like characteristics (the "Subordinated Notes"). However, the Subordinated Notes represent a very small portion of the overall capital structure and are frequently owned by the adviser or its affiliate. As a result, the limited additional benefit of the Proposed Reforms with respect to Subordinated Note holders are greatly outweighed by the additional costs that would have to be borne by the CLO.

for these services). These costs and risks are not justified because these types of vehicles do not constitute the types of third-party relationships that might be deemed to create conflicts of interest that are of concern in these Proposed Reforms, and the additional costs and risks of the Proposed Reforms are unjustified for an adviser receiving no compensation.

f. Advisers' Decisions to Disclose Should Not Subject Them to Compliance

Relatedly, there are certain situations in which advisers choose to include clients that are not technically private funds in item 7.B.(1) of Schedule D of Form ADV or on regulatory filings such as Form PF in light of a desire to provide the Commission and investors with additional information even where it is not required (for example, in the case of funds of one or real estate funds that are organized as 3(c)(5)(C) entities). In such cases, the Commission should make clear that the inclusion of these entities in such filings will not automatically lead to a determination that the Proposed Reforms should apply to them. Any lack of clarity on this point could lead to advisers choosing not to voluntarily disclose information related to these clients at the risk of triggering costly regulatory burdens.

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Again, we thank you for the opportunity to provide these comments. If you have any questions regarding our comments, please feel free to contact Amanda N. Persaud at [redacted] Joel A. Wattenbarger at [redacted] or Jeremiah L. Williams at [redacted].

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