April 25, 2022

Via Electronic Filing

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (SEC Rel. No. IA–5955; File No. S7–03–22)

Dear Ms. Countryman:

The Investment Adviser Association (IAA)\(^1\) appreciates the opportunity to comment on the Commission’s rule proposal regarding private fund advisers and documentation of registered investment adviser compliance reviews.\(^2\) In the Proposal, the Commission cites to the large number of private funds and the amount of assets under management devoted to them, and proposes a number of rules with the stated intention of increasing transparency and reducing private fund sponsor conflicts of interest.

While we support increased transparency and addressing investor protection concerns, we do not believe that a departure from the principles-based approach to the Advisers Act is warranted. In our view, the Commission’s proposed remedy is overbroad and there are more narrowly-tailored solutions that would achieve the Commission’s objective without the many unintended consequences for investors and investment advisers likely to result from the Proposal. Private funds offer significant benefits to investors and the capital markets. These include, for example, portfolio diversification and risk management for investors and vital investment capital for companies. The excessive scope of the Proposal would raise costs and complexity for investors and create barriers to entry in this industry. It would make the business model for private funds much more expensive and inefficient, without a commensurate investor benefit, and would be likely to result in a less competitive industry, all of which are contrary to the Commission’s stated goals. For these and the reasons discussed below, we largely oppose the overbroad Proposal and

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\(^1\) The IAA is the leading organization dedicated to advancing the interests of investment advisers. For more than 80 years, the IAA has been advocating for advisers before Congress and U.S. and global regulators, promoting best practices and providing education and resources to empower advisers to effectively serve their clients, the capital markets, and the U.S. economy. The IAA’s member firms manage more than $35 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. For more information, please visit [www.investmentadviser.org](http://www.investmentadviser.org).

offer more tailored alternatives that we believe will achieve the Commission’s objectives.

**EXECUTIVE SUMMARY**

Following a statement of our key concerns that apply to multiple elements of the Proposal, we address each of the Proposal’s topics in turn, in an order intended to reflect the magnitude of the impact on the IAA’s members.

I. **Key Concerns.** In Section I, we discuss several key concerns raised by the Proposal, including:

a) *Approach to the Advisers Act.* We strongly oppose proposed Rules 211(h)(2)-1, private fund adviser prohibited activities, and Rule 211(h)(2)-3, preferential treatment, and urge the Commission to withdraw these parts of the Proposal. Outright prohibitions for private fund advisers are inconsistent with the Commission’s longstanding and recently-reaffirmed principles-based approach to regulation of investment advisers under the Investment Advisers Act of 1940 (*Advisers Act*). The Commission has not sufficiently justified such a radical departure from this well-established framework.

b) *Disrupting Contractual Provisions.* The Proposal would disrupt agreements negotiated by parties that Congress deemed sophisticated enough to enter into such agreements.

c) *Retroactive Application.* Retroactive application of the proposed rules would be unfair and unduly burdensome to investment advisers and investors, neither of which would be able to enforce negotiated contractual provisions.

d) *Unmanageable Conflicts.* The Commission has not provided sufficient support for its selection of conflicts it deems unmanageable.

e) *Insufficient Time for Comment and Consideration.* The Commission underestimates the Proposal’s impact and has provided insufficient time for thorough comment and consideration, especially given the enormous breadth and complexity of the Proposal.

f) *Economic Analysis.* The Commission has not adequately assessed the economic impact of the Proposal on private fund advisers, including on smaller and emerging managers.

II. **Private Fund Adviser Prohibited Activities.** In Section II, we address the proposed private fund adviser prohibited activities:

a) *General Considerations.* We strongly believe that the proposed prohibitions should be withdrawn. However, if the Commission decides to proceed, we offer several alternatives, each of which would be a reasonable and less restrictive alternative to those included in the Proposal.
b) Limitation of Liability and Indemnification. We oppose the proposed prohibition on a private fund adviser’s use of a liability-limiting or indemnification provision. While we would support a renewed Commission statement that Governing Documents may not purport to waive the federal fiduciary duty, we cannot agree that advisers should be unable to limit their liability or be indemnified for negligence in their reasonable and good faith management of a private fund. We strongly object to the Commission’s characterization of such conduct as malfeasance or misconduct.

c) General Partner Clawbacks. The Commission should not prohibit adviser clawbacks for taxes, which would put advisers in a worse after-tax position than if no investor-protective clawback provision had been included at all.

d) Fee and Expense Allocations. We urge the Commission to more appropriately tailor rules related to pro rata fee and expense allocations.

e) Prohibited Fees and Expenses. We understand the Commission’s concerns regarding the charging of certain fees and expenses and offer recommendations to address those concerns.

f) Borrowing. We ask the Commission to clarify that certain permissible activities would not be deemed to be borrowing.

g) Preferential Treatment. We believe that the Commission underestimates the complexity of the broad proposed preferential treatment provision and that it would not be workable for several reasons. We offer alternatives that we believe would be more practicable and still achieve the Commission’s goals.

III. Quarterly Statements. We urge the Commission to simplify and tailor the complex and confusing proposed quarterly statement reporting requirements relating to fees and expenses and performance to better reflect current investor-beneficial market practices. It should also extend the deadline for the quarterly report from the proposed 45 days to 60 days after quarter-end, with additional time given to fund-of-funds and certain other adjustments.

IV. Private Fund Audits. We believe the Commission should not use this Proposal to effectively amend Advisers Act Rule 206(4)-2 (Custody Rule). Instead, the Commission should propose amendments as part of a holistic review of the Custody Rule, and provide adequate time for stakeholder feedback. In the event the Commission nevertheless proceeds, we include recommendations that would better tailor the Proposal to achieve the Commission’s objectives.

V. Adviser-Led Secondary Transactions. We recommend that, to reduce the complexity and costs of the proposed requirement to obtain an independent fairness opinion for adviser-led secondary transactions, the Commission provide an exemption where an unaffiliated third party or other independent source sets the price, for example through a competitive auction.

VI. Annual Reviews. We support the proposal to require advisers to document their annual reviews under the Compliance Program Rule.
We provide our specific comments and recommendations on each of these and other topics below.

I. **KEY CONCERNS**

a. **Outright Prohibitions Are Inconsistent with the Commission’s Longstanding and Recently-Reaffirmed Approach to Regulation of Investment Advisers and are Not Sufficiently Justified**

We strongly oppose the Commission’s proposal to impose outright prohibitions on certain contractual provisions, which contravenes the Commission’s historical approach to regulation under the Advisers Act and is not sufficiently justified. As fiduciaries, private fund advisers have an overarching duty to act in their clients’ best interest, including a duty of loyalty and a duty of care. Fiduciaries must make full and fair disclosure of conflicts of interest and address or mitigate those conflicts so that the conflicts do not taint their advice. The principles-based fiduciary duty was “reaffirm[ed], and in some cases clarify[ied],” in the Commission’s July 2019 Fiduciary Interpretation:

The relationship between an investment adviser and its client has long been based on fiduciary principles not generally set forth in specific statute or rule text. We believe that this principles-based approach should continue as it expresses broadly the standard to which investment advisers are held while allowing them flexibility to meet that standard in the context of their specific services.

The Fiduciary Interpretation also emphasized that:

The fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent… In our experience, the principles-based fiduciary duty imposed by the Advisers Act has provided sufficient flexibility to serve as an effective standard of conduct for investment advisers, regardless of the services they provide or the types of clients they serve.

Although all investment advisers owe each of their clients a fiduciary duty under the Advisers Act, that fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client.

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4 Fiduciary Interpretation at 33670.

5 Fiduciary Interpretation at 33671.
An approach that involves outright prohibitions and broad one-size-fits-all requirements undercuts this flexibility to the potential detriment of investors. Investor protection concerns were front and center in the Fiduciary Interpretation, and neither the private funds industry nor the need for investor protection has changed so appreciably in the fewer-than-31 months between the Fiduciary Interpretation and the date of the Proposal as to support the Commission’s departure from its recently-reaffirmed framework.

Moreover, this regime has provided the Commission with effective tools to successfully pursue private fund advisers for fees or penalties relating to the matters covered by the Proposal. In addition, Rule 206(4)-8 explicitly makes it a “fraudulent, deceptive, or manipulative act, practice, or course of business” for an adviser to a private fund to “engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.”

It is unnecessary and duplicative to adopt new rules under Section 211(h) for private fund advisers on top of the Commission’s existing authority. The Commission can and has brought enforcement actions against private fund advisers for misconduct under Advisers Act Section 206 and Rule 206(4)-8. The amount of disgorgement involved in these cases undercuts the Proposal’s arguments that the Commission does not currently have the tools to prevent bad conduct and that it therefore needs outright prohibitions to protect investors.

We are also concerned that adoption of Rule 211(h)(2)-1 as proposed would set a troubling precedent because it would apply prescriptive requirements under the Advisers Act to a particular type of investment. Abandoning the flexibility and broad application of the Advisers Act’s fiduciary duty framework would end up harming the Commission’s broad mandate to adapt its regulatory expectations to the particular facts and circumstances and potentially cause market

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6 “The fiduciary duty an investment adviser owes to its client under the Advisers Act, which comprises a duty of care and a duty of loyalty, is important to the Commission’s investor protection efforts.” Fiduciary Interpretation at 33669.

7 Proposal at 16888 (citing SEC enforcement actions). When adopting Rule 206(4)-8, the Commission stated that it did not want to identify specific fraudulent conduct in the rule text because it did not want to provide a “roadmap for those wishing to engage in fraudulent conduct,” noting that that “approach would be inconsistent with our historical application of the federal securities laws under which broad prohibitions have been applied against specific harmful activity” (rejecting commenters’ recommendations that the SEC restrict the scope of the rule to more narrowly define the conduct or acts it prohibits). See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, SEC Rel. No. IA-2628, 72 Fed. Reg. 44756, 44757, 44759 (Aug. 9, 2007), available at https://www.sec.gov/rules/final/2007/ia-2628fr.pdf. See also Proposal at 16936, 16973 (discussing Proposal’s relation to and overlap with Rule 206(4)-8).

8 By way of example, accelerated monitoring fees would be expressly prohibited by proposed Rule 211(h)(2)-1(a)(1). However, the Commission previously has been able to obtain noteworthy amounts of disgorgement and penalties in settled orders against private fund advisers that took these fees. See, e.g., In the matter of Blackstone Management Partners L.L.C. et al, Investment Advisers Act Rel. No. 4219 (Oct. 7, 2015) (settled action), available at https://www.sec.gov/litigation/admin/2015/ia-4219.pdf; In the matter of Apollo Management V, L.P. et al, Investment Advisers Act Rel. No. 4493 (Aug. 23, 2016) (settled action), available at https://www.sec.gov/litigation/admin/2016/ia-4493.pdf; and In the matter of TPG Capital Advisors, LLC, Investment Advisers Act Rel. No. 4830 (Dec. 21, 2017) (settled order), available at: https://www.sec.gov/litigation/admin/2017/ia-4830.pdf. Each of these cases was brought on “failure to disclose” grounds based on (among others) existing Advisers Act Sections 206(2) and 206(4), as well as Advisers Act Rule 206(4)-8. Following these orders, our understanding is that industry use of accelerated monitoring fees diminished significantly.
participants to apply a “check-the-box” approach to their fiduciary duty that could disserve investors.\textsuperscript{9} Instead, the Commission should continue to focus on enforcing the fiduciary duty under the principles-based Advisers Act framework.

\textbf{b. The Proposal Would Disrupt Agreements Negotiated by Sophisticated Parties}

We are also concerned about the troubling precedent that is being set by the Commission’s use of Section 211(h) to disrupt agreements that have been negotiated between investment advisers and investors in their sponsored private funds, with the goal of eliminating practices that are “contrary to the public interest and the protection of investors.”\textsuperscript{10} Many of the contractual provisions that are the subject of the Proposal are widely accepted in the market and have evolved over several decades in response to market pressures and negotiations between private fund sponsors, sophisticated investors, and experienced counsel representing both parties.

The Proposal cites to “everyday Americans saving for retirement or college tuition” and to categories of private fund investors that the Commission appears to view as similar or adjacent to retail investors: state and municipal pension plans; college and university endowments; non-profit organizations; and high net worth individuals.\textsuperscript{11} However, in doing so the Proposal overlooks the fact that most private funds are established in reliance on the exemption found under Section 3(c)(7) of the Investment Company Act of 1940 (\textit{ Investment Company Act}), which requires that investors meet the Investment Company Act’s “qualified purchaser” standard (in most cases requiring investors to own $5 million in defined categories of “investments” if they are individuals, and $25 million in “investments” if they are entities). Private funds established in reliance on the exemption found under Section 3(c)(1) of the Investment Company Act, although fewer in number, generally require that investors be both “accredited investors,” as defined under the Securities Act of 1933 and “qualified clients” as defined under Rule 205-3 of the Advisers Act. Investors in these private funds by definition are sophisticated investors that Congress has deemed able to fend for themselves.

The Proposal also fails to acknowledge that state and municipal pension plans, as well as pension and similar plans subject to the Employee Retirement Income Security Act of 1974 (\textit{ERISA}) and other categories of retail-adjacent investors cited by the Commission, generally are represented by sophisticated counsel, boards, and other advisers with a reputation for representing investors in private funds. These investors regularly present private fund sponsors with highly detailed and considered comment memoranda and side letter requests relating to provisions in the private fund’s limited partnership agreements or investment management agreements (together,

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\textsuperscript{9} We note that the Commission recently amended the Advertising and Solicitation Rules under the Advisers Act to remove \textit{per se} prohibitions that, over the years, had proven overly complex and largely unworkable in favor of a flexible and evergreen principles-based new Marketing Rule. In adopting the final rule, the Commission explicitly recognized the benefits of a principles-based approach for addressing evolving technology, investor expectations, and diversification in the investment adviser landscape. \textit{See Investment Adviser Marketing (Marketing Rule)}, 86 Fed. Reg. 13024, 13025 (Mar. 5, 2021), available at https://www.govinfo.gov/content/pkg/FR-2021-03-05/pdf/2020 28868.pdf.
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\textsuperscript{10} E.g., Proposal at 16890.
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\textsuperscript{11} Proposal at 16887.
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the Governing Documents) that then must be evaluated and addressed in connection with arms’-length pre-investment negotiations. The Proposal inappropriately dismisses the substantial bargaining power held by these investors, as well as the substantial time and attention devoted by private fund advisers to addressing and accommodating their requests.  

   c. Retroactive Application Would Be Unfair to Investment Advisers and Investors

   The Proposal seeks to apply the new prohibitions and other elements of the Proposal to existing contractual arrangements, some of which were entered into a decade before, without exemption or accommodation for arrangements that were entered into prior to the effective date of any final rules. To the extent the Proposal’s requirements must be implemented on a retroactive basis, the Commission risks unfairly favoring one party to an existing contract over the other, and in many cases disfavoring investors. For example, prohibitions implicating information rights generally would disadvantage the investors that have negotiated for those rights, and that have in many cases entered into a private fund investment conditioned on receiving such information. Retroactive application would put investment advisers in the difficult place of not being able to honor the terms of Governing Documents they have signed with their investors even where these are terms that were negotiated by the investors. Further, to the extent the Commission requires existing Governing Documents to be amended, the resultant costs of redrafting and re-negotiating the Governing Documents would vastly exceed those contemplated by the Commission’s cost-benefit analysis in the Proposal. A prospective application, on the other hand, would permit both investment advisers and their private fund investors to enter negotiations with the same rules of play, and identify key areas of concern both inside and outside the topics covered by the Proposal, in negotiating Governing Documents of future private funds.

   d. The Commission Does Not Provide Sufficient Support for Its Selection of Conflicts it Deems Unmanageable

   The Proposal concedes that, of the conflicts of interest, problematic sales practices, and compensation schemes observed by the Commission, “some can be managed.” To this end, the Commission references conflicts of interest in: (i) valuation matters, along with citations to consent orders that were based on valuation and mispricing matters; and (ii) adviser-led secondary transactions. However, the Commission does not sufficiently support, in data or

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12 We believe that any adopted requirements or other prohibitions are also not necessary for separately managed accounts. There should be no need to apply additional substantive requirements or prohibitions in this context given the robust existing protections under the Advisers Act regulatory regime.

13 The Supreme Court has noted that “[r]etroactivity is not favored in the law” and held that “a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms.” Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208 (1988).

14 We note that, because the overwhelming majority of private fund Governing Documents specify that the costs of negotiating and amending the Governing Documents are “partnership expenses,” these costs generally would be borne by investors.

15 Proposal at 16889.
otherwise, its distinction between the practices that “can be managed” and the practices that are subject to the Proposal’s rulemaking. Instead, it applies unclear standards to select practices that it deems so problematic as to require outright prohibitions or other rulemaking in the Proposal. We see no reason why these conflicts also should not be able to “be managed.” For example, as we explain below, we believe that appropriately tailored policies and procedures and disclosure could be used to manage these conflicts. Similarly, the Commission has failed to identify how its expressed preferences regarding allocation of private fund partnership profits relate to a compensation scheme that cannot “be managed,” and must be addressed with a prohibition on certain tax-related clawback reductions.

e. The Commission Underestimates the Proposal’s Impact, and Should Provide Additional Time for Comment and Consideration

We are concerned that the Commission underestimates the impact of the Proposal on investors, advisers, and private funds. There may be practical considerations or unintended consequences that need to be more fully considered and explored. Given the enormous breadth of the Proposal and the amount of work that would be required to implement and apply the Commission’s intended provisions, we are concerned that the Proposal’s short comment period is insufficient for commenters, including the IAA, to provide extensive and thoughtful responses. The Commission has posed more than 900 questions in the Proposal, and performed a preliminary cost-benefit analysis that vastly underestimates the time and expense of implementing and complying with the new rules. We believe that the Proposal’s brief comment period will not permit meaningful replies to each of these questions, or reliable data to be gathered in order to determine whether its cost-benefit analysis is accurate. In light of these factors, and the importance and complexity of the issues involved, the IAA and 24 other trade associations have separately urged the Commission to lengthen the comment periods relating to the Proposal and other recent Commission proposals.16

16 The Proposal is one of several concurrent rule proposals that, if adopted, will have an enormous effect on investment advisers, investors, the markets, and the U.S. financial system as a whole. Each of these proposals, standing alone, is complex and potentially consequential, with the accompanying releases asking a large number of questions and seeking a large amount of data. Given the significant amendments proposed, we continue to be concerned that the very short comment period – for this and all the other proposals – is insufficient for us and other commenters to provide comprehensive and sufficiently thorough responses, including “supporting data and analysis.” Proposal at 16960.

As we recently expressed, we do not believe the SEC has provided sufficient time for considered public input on the Proposal; a comment period for this Proposal of at least 60 days from publication in the Federal Register would have been more appropriate. See IAA and Joint Trade Associations’ Letter on Importance of Appropriate Length of Comment Periods (Apr. 5, 2022), available at https://investmentadviser.org/resources/iaa-and-trade-associations-urge-sec-to-lengthen-short-comment-periods/ and IAA and Joint Trade Associations’ Letter Requesting Extension of Comment Period for Private Fund, Form PF Proposals (Mar. 1, 2022), available at https://investmentadviser.org/wp-content/uploads/2022/03/Extension-Request-File-Nos.-S7-03-22-S7-01-22.pdf. We strongly urge the Commission to formally extend the comment period in order to undertake a more quantifiable assessment of the costs the Proposal would impose on investment advisers. We look forward to continuing our engagement with the Commission and its Staff as we further consider these and the many other important questions and issues raised in the Proposal.

Some of the other significant rule proposals recently out for comment are: Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, 87 Fed. Reg. 13524
f. Economic Analysis and Cumulative Impact of Regulation

We urge the Commission to conduct a more realistic and thorough assessment of the costs of the Proposal on advisers of all sizes, and on smaller advisers in particular. The vast majority of SEC-registered investment advisers are small businesses by any logical measure and they face unique challenges. Smaller advisers have been significantly burdened by one-size-fits-all regulations—both in isolation and cumulatively—that effectively require substantial fixed investments in infrastructure, personnel, technology more broadly, and systems relating to documentation, contract negotiation, monitoring, operations, custody, business continuity planning, and more. Unfortunately, under current federal regulations, the Commission is not required to conduct a realistic analysis of the impact the Proposal would have on smaller SEC-registered advisers, and we believe that the Proposal thus severely underestimates the costs and burdens that would be imposed on smaller firms. We recommend that the Commission utilize the ever-increasing amount of data at its disposal to make a more realistic assessment of the impact the Proposal would have on smaller advisers.

17 For example, the median number of non-clerical employees of SEC-registered investment advisers was eight at the end of 2020, with 58 percent of SEC-registered advisers having fewer than 10 non-clerical employees and 87.9 percent having fewer than 50 non-clerical employees. See IAA-NRS Investment Adviser Industry Snapshot 2021 (July 2021), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2d7b7e8/UploadedImages/publications/industry-snapshots/Investment_Adviser_Industry_Snapshot_2021.pdf.

18 As a practical matter, the Commission is not required to analyze the economic impact of its regulations on small advisers because, inexplicably, the Proposal’s definition of “small entity” includes only advisory firms with less than $25 million in AUM, while, with rare exceptions, an advisory firm must have a minimum of $100 million AUM to fall under SEC jurisdiction. We have long urged the Commission to reconsider this definition and, for example, consider other factors in addition to a more meaningful AUM (e.g., number of employees), to make a more realistic assessment of the impact of rules on smaller SEC-registered advisers that by their nature have limited staffing. In our view, the Proposal’s definition makes the Proposal’s economic impact analysis on smaller advisers virtually meaningless. Moreover, because implementation of new rule requirements depends largely on financial and human resources, using an AUM-based test as the only measure risks missing the true burdens on smaller advisers.
We also urge the Commission to step back and consider holistically the cumulative impact of all its regulations on investment advisers. For example, advisers’ implementation of the sweeping new Marketing Rule, adopted by the Commission in December 2020, calls for a significant allocation of personnel and operational resources.\textsuperscript{19} A holistic assessment of the impact of the Commission’s regulations is particularly important for smaller advisers. According to the Commission’s Asset Management Advisory Committee (AMAC):

Given the breadth, scope, and depth of the regulatory requirements on all registrants and considering the growing aggregate or cumulative impact of compliance costs on the balance sheet health of small advisers/funds, economic analysis done in a vacuum has limited utility. While economic analysis on a rule-by-rule basis is necessary, it is insufficient to provide the Commission (and public commenters) the picture necessary to be fully informed in considering and commenting on rulemaking initiatives.\textsuperscript{20}

II. PRIVATE FUND ADVISER PROHIBITED ACTIVITIES

a. General Considerations

In its proposed form, new Advisers Act Rule 211(h)(2)-1 would involve an outright ban on a number of activities by investment advisers, directly or indirectly, with respect to private funds and investors in private funds. Under this ban, certain specified activities by any investment adviser to a private fund would be \textit{per se} unlawful under the Advisers Act, notwithstanding any (i) prior disclosure to investors, (ii) contractual authorization in fund Governing Documents, or (iii) approval of limited partners, or advisory boards or other bodies selected to represent them. These prohibitions are unnecessary and, as described in Section I above, are inconsistent with the Commission’s approach relating to the overarching, principles-based Advisers Act framework for investment advisers that was recently reaffirmed in the Fiduciary Interpretation.\textsuperscript{21} We believe that the proposed contractual prohibitions should be withdrawn.

If the Commission decides to proceed with the prohibitions, we offer the following alternatives to contractual prohibitions, each of which would be a reasonable and less restrictive alternative to those included in the Proposal:

- \textit{Prohibitions Should Apply Solely Absent Prior Disclosure or Approval}. The Commission is right to ask if, instead of enacting prohibitions relating to the enumerated items, the rule should “prohibit these activities unless the adviser

\textsuperscript{19} See Marketing Rule, \textit{supra} n. 9.


\textsuperscript{21} If adopted as proposed, the Proposal would also effectively result in the rare imposition of substantive prohibitions on existing private fund Governing Documents without an express statutory mandate relating to these prohibitions. \textit{See supra} n. 13.
satisfies certain governance and other conditions (e.g., disclosure to investors in all relevant funds/vehicles, approval by the limited partner advisory committee (or other similar body) or directors)?...". We emphatically agree. As an alternative to blanket prohibitions, we strongly recommend that Rule 211(h)(2)-1 should prohibit the listed activities only to the extent that such activities have not been (i) fully and fairly disclosed to investors in all relevant funds or vehicles and (ii) included in Governing Documents or approved by the limited partner advisory committee (or other similar body) or directors. This approach would be more consistent with the framework of the Advisers Act. It would permit the Commission to make clear that these specific activities would be prohibited in the absence of disclosure and governance steps. It would also prevent the Commission from taking the approach, questionable on public policy grounds, of interfering in Governing Documents negotiated between investment advisers and sophisticated private fund investors.

- **Prohibitions Should Be Applicable Solely on a Prospective Basis; No Amendments to Governing Documents Should Be Required.** We have discussed already the unfair and, in some cases, investor-disadvantageous nature of retroactive application of the Proposal. We are concerned that the Commission discusses transition issues for funds that existed before the compliance date of the proposed rules (the Compliance Date) only in the context of quarterly reporting, and not in the context of the prohibited practice rules, and in doing so ignores the monumental changes in adviser-investor dynamics that any adopted prohibitions would create. For these reasons, to the extent the Commission is not persuaded to withdraw the Proposal’s prohibited practice rules entirely, any prohibitions adopted by the Commission under Rule 211(h)(2)-1 should apply only to private funds that have a first closing on or after the Compliance Date. Failing that, to the extent that the Commission intends to apply any prohibitions retroactively, the Commission should not require investment advisers to private funds to amend the affected Governing Documents to match the rules as adopted; instead, investment advisers should be permitted to provide unilateral notice to affected private fund investors that, based on the retroactive effect of the rules, it will either disapply or not seek to enforce affected provisions of the Governing Documents.

- **Prohibitions Should Not Apply to Non-U.S., State-Registered, or Exempt Reporting Advisers (ERAs).** As proposed, Rule 211(h)(2)-1 has a sweeping scope that would apply to all investment advisers to private funds, whether registered with the Commission or exempt. As a result, many prohibitions, if adopted, would apply to state-registered advisers, as well as U.S. and non-U.S. ERAs, and would upend the careful consideration that determined the scope of the Advisers Act’s authority over non-U.S. advisers in the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), as well as the balance of federal and state authority over smaller advisers in the National Securities Markets Improvement Act of 1996 (NSMIA). The Proposal has not supported the argument

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22 Proposal at 16921.

23 Proposal at 16934.
that the boundary stones set by Dodd-Frank and NSMIA should be moved. Moreover, as acknowledged in part by the Commission, the Commission’s economic analysis fails to take fully into account the substantial economic impact that the Proposal would have on state-registered and non-U.S. investment advisers, as well as the Proposal’s interference with the authorities over those jurisdictions and their right to regulate investment advisers in their purview.

Further, the Commission is right to note in the Proposal that it has “historically taken the position that most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients (including funds) of a registered offshore adviser,” and to ask whether “registered offshore advisers should not be subject to [the rule] with respect to their offshore private fund clients or offshore investors.” We agree. Any investor protection concerns underlying the Proposal are no more significant than those with respect to which registered offshore advisers have historically received relief from the Commission, and so Rule 211(h)(2)-1 should not apply to the offshore private fund clients or offshore investors of registered offshore advisers.

b. Indemnities/Limitation of Liability

Proposed Rule 211(h)(2)-1(a)(5) would prohibit an investment adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund. The Commission cites to Governing Documents recently encountered by its Staff that purport to waive an adviser’s fiduciary duties under the Advisers Act, among other purported waivers. In this sense, the Commission’s concern is understandable, and we agree with the Proposal and the Commission’s historical precedent, whether under Advisers Act Sections 206, 215(a), or otherwise, that an investment adviser’s federal fiduciary duties under the Advisers Act are not waivable. Indeed, we would support a renewed statement by the Commission reminding investment advisers to private funds that they may not include in Governing Documents a provision purporting to waive their federal fiduciary duty.

We also understand the Commission’s concerns in reviewing Governing Document provisions that purport to indemnify for willful misfeasance, bad faith, or recklessness; however, we believe that prohibiting reimbursement for acts that constitute negligence would be a sweeping change, the impact of which cannot be overstated, and would be untenable for the activities and operations of private funds. Investment advisers to private funds are paid by their investors to take calculated risks in investment matters, and advisers cannot effectively manage the risks of making and managing investments without limitation of liability and indemnification. Clauses that limit liability or permit indemnification for negligence are necessary to allow investment advisers to

24 See, e.g., the Proposal’s discussion at 16970.

25 Proposal at 16921.

26 Id.
private funds to manage effectively the risks of making and managing investments.\textsuperscript{27} This is particularly important with respect to operating companies owned by private equity funds, which require a level of engagement and activity well beyond that required by many other kinds of investments. In no circumstances do we believe that the Commission should adopt any rule that imposes a “strict liability” standard on investment advisers.

In addition, in seeking to amend or nullify, in whole or in part, substantially every liability-limiting and indemnification provision in every Governing Document of every private fund, the Commission undertakes an unprecedented override of contractual arrangements between sophisticated parties, and treads on the delicate balance of these negotiated provisions. The potential economic effects of re-negotiating and revisiting these provisions across the private funds industry would be substantial.

In prohibiting limitation of liability and indemnification terms, the Proposal:

\begin{itemize}
  \item without justification establishes a higher liability standard (amounting to something close to strict liability) for investment advisers to private funds with sophisticated investors than for registered funds with retail investors;\textsuperscript{28}
  \item treats as the equivalent of “adviser misconduct” or “willful malfeasance” items that would constitute unintentional mistakes made in pursuit of a private fund’s investment objectives in good faith;
  \item treats liability-limiting and indemnification clauses as if the relevant investment adviser were seeking \textit{permission to act in} bad faith or in a manner that is grossly negligent with respect to its private funds, when those provisions in many cases are necessary to defend against plaintiffs’ \textit{allegations} relating to purported misconduct, for example after a fund loses money even when the adviser acted consistently with its fiduciary duty;
  \item leaves ambiguous, in its “direct or indirect” formulation, whether an adviser and its personnel would be permitted to seek limitation of liability or indemnification for private fund portfolio company-related liabilities, ignoring the fact that portfolio company-related litigation regularly involves plaintiffs’ allegations of violation of state fiduciary duties as a “catch all” claim, whether or not the plaintiff is then aware of any conduct that implicates these duties. Any adopted version of the Proposal should clarify that limitation of liability or indemnification requirements
\end{itemize}

\textsuperscript{27} We also note that current private fund liability-limiting and indemnification standards are not stand-alone provisions, but are part of the balance negotiated between a private fund adviser and its investors. If advisers will now bear all the risks relating to their activities, there may be a measurable increase in adviser fees and private fund expenses to compensate the adviser and limit the effects of that risk-bearing role.

\textsuperscript{28} As the Commission is aware, Section 17(i) of the Investment Company Act prohibits contractual provisions that purport to protect an investment adviser to a registered investment company (RIC) against liability for “willful misfeasance, bad faith, or gross negligence” in the performance of its duties, or “reckless disregard” of its contractual obligations. The Proposal alters and heightens this statutory standard in the private fund context in several ways, including by substituting ordinary negligence for gross negligence. This is an even more concerning result considering that private funds are subject to the sophistication standards described in \textbf{Section 1.b} above, where investors in RICs are not.
apply solely to advisory services provided by the adviser;

- leaves ambiguous, in prohibiting “seeking reimbursement, indemnification, exculpation, or limitation of … liability,” whether the prohibited conduct in question is actually charging a private fund for these amounts or merely entering into (or maintaining) Governing Documents that contain these provisions;

- brings into question the enforceability of the many longstanding parameters of private fund limitation of liability and indemnification provisions that do not relate expressly to a standard of care, but distinguish liability in certain circumstances, e.g., where an investment adviser is permitted to rely on professional advice where counsel, tax advisors, accountants, or other experts have been consulted;

- creates the risk that private fund service providers themselves will want to re-open negotiations for service provider engagement agreements due to changes in the private fund adviser’s potential liabilities; and

- interferes with limitation of liability regimes that are permitted under state laws and the laws of many non-U.S. jurisdictions where private funds are formed, incorporated or organized. For example, Section 145(a) of the Delaware Code provides default indemnification provisions widely used by American corporations, and permits indemnification for negligence.

For the reasons discussed above, we oppose the proposed prohibition on liability-limiting and indemnification clauses.

c. Adviser Clawbacks for Taxes

Proposed Rule 211(h)(2)-1(a)(4) would also prohibit all private fund advisers 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. In addition to the rationales referenced above, the Commission states a particular concern that reduction for taxes puts an adviser’s interests ahead of private fund investors’ interests, even where such practice is disclosed in the relevant Governing Documents.

We believe that this element of the Proposal should be withdrawn, for the reasons discussed below and in Sections I and II.a. Because tax losses (if any) recognized by an adviser or its related persons in connection with a clawback payment generally are subject to substantial limitations under U.S. income tax rules, including in most cases a prohibition on carrying back such tax losses, proposed Rule 211(h)(2)-1(a)(4) would in many cases put advisers in a worse after-tax position than if no performance-based compensation had been charged at all. This cannot be the result contemplated by the Commission.

Many private equity funds include an investor-favorable clawback mechanism that obligates a carried interest recipient to return early-period carried interest distributions that are subsequently calculated to be excessive after taking into account unfavorable later period results. Private funds are not required to include investor-favorable clawbacks and, as a threshold matter, it is difficult to see the logic of a rule that would require that, if such a clawback were included, it would need to be even more investor favorable.
The Proposal’s stated purpose in this regard is to protect “the interests of investors to receive their share of fund profits.” This purpose has a fundamental flaw, however, in that the investors’ “share of fund profits” is a matter appropriately to be negotiated between private fund investors and advisers, and the Commission has not established a basis in law or public policy, or on investor-protection grounds, to mandate that profits be shared between private fund investors and advisers in specific amounts or percentages. The manner in which proceeds generated by a private fund are shared between private fund investors and advisers is at the center of economic negotiations between the parties. In practice, both the timing of proceeds sharing and the ultimate profit-sharing ratios are negotiated points, where private funds return investor capital before making carried interest distributions (a “European waterfall” approach) and other private funds make carried interest distributions on an ongoing basis as investments are realized (an “American waterfall” approach). We note that some private funds set a preferred return threshold before the fund sponsor is entitled to carried interest distributions; other private funds do not. Many private funds set the adviser’s target carried interest share of profits at 20 percent of cumulative fund profits; some private funds provide for higher or lower carried interest percentages. These terms, and their related negotiations, are subject to real-time trends and factors in the world of private fund marketing, and vary by type of private fund, size of sponsor, demand for the sponsor’s services, and other factors that we understand may change from year-to-year and even from month-to-month.

As part of carried interest negotiations, private equity fund investors typically negotiate for a right to receive a return of carried interest distributions from the adviser to the extent early period carried interest distributions are determined to be excessive on a cumulative basis. Private fund advisers typically negotiate for a right to receive and retain carried interest distributions in an amount that is not less than the sponsor’s potential tax liability attributable to the carried interest (typically calculated based on a formula stated in the Governing Documents). Sponsors seek this tax liability floor to carried interest distributions on the ground that the carried interest is intended to provide incentive remuneration and there should not be circumstances where this incentive remuneration may be negative on an after-tax basis.

A tax liability floor to carried interest distributions is typically implemented through two common provisions in private equity fund Governing Documents. First, the distribution provisions of these Governing Documents typically give the sponsor a priority right to receive carried interest distributions equal to an assumed carried interest tax liability amount. For example, while these Governing Documents using a “European waterfall” generally return investor capital before making carried interest distributions, the Governing Documents typically allow the sponsor to receive carried interest distributions equal to an assumed carried interest tax liability amount before investor capital is returned. Second, the clawback provisions of private equity fund Governing Documents typically limit the clawback amount to an amount that would not cause cumulative unreturned carried interest distributions to be less than an assumed carried interest tax liability amount. Under this clawback limitation, a “dollar-for-dollar” giveback is required up to the amount of assumed carried interest tax liability. These two related provisions, which provide

29 Proposal at 16924.

30 For example, assume that a private fund adviser is generally entitled to carried interest at a 20 percent rate. It receives early-year carried interest allocations and distributions of $1,000 (20 percent of $5,000), with such
a floor on current period carried interest distributions and a cap on carried interest clawbacks, have
become widely accepted between private fund investors and advisers as a reasonable response to
U.S. tax rules that could otherwise produce negative after-tax carried interest amounts.

As the Commission may be aware, U.S. income tax rules require partners of a partnership
to pay annual tax based on the amount of partnership income allocated to the partner, rather than
based on the amount of partnership distributions received by the partner in the applicable year.
These tax rules allocate annual income to partners based on how this income would be shared
assuming a liquidation of the partnership at the end of the year. Under these tax rules, a private
fund adviser may be allocated substantial carried interest taxable income in a year but be entitled
to little or no carried interest distributions under the general distribution waterfall (particularly if
the relevant fund uses a European waterfall). The typical carried interest tax liability floor on
carried interest distributions protects the sponsor from negative after-tax carried interest in this fact
pattern.

Moreover, carried interest clawbacks typically arise in situations where a private equity
fund recognizes income or gains in one or more early years that result in carried interest
allocations and distributions and, in a later year, recognizes losses. The Proposal appears to
assume that, in this fact pattern, carried interest recipients could recover the earlier-year carried
interest taxes, including by amending earlier-year tax returns. This assumption misunderstands the
way the U.S. tax rules work. In the clawback fact pattern, carried interest recipients generally will
be allocated a later year capital loss corresponding to the clawback obligation. But U.S. income tax
rules place significant limits on an individual’s ability to utilize capital losses. In particular, capital
losses cannot be carried back to earlier years and (except for a $3,000 annual deductible amount)
may be deducted in current and future years only against capital gains (and not against
compensation or other ordinary income). These limitations restrict private fund sponsors from
recovering carried interest taxes paid in earlier years. The typical carried interest tax liability cap
on carried interest clawbacks found in private equity fund Governing Documents protects the
sponsor from negative after-tax carried interest distributions in this fact pattern.

Unsurprisingly, private fund investors generally would prefer that there not be a tax
liability floor to carried interest distributions (either in the calculation of annual distributions or in
the calculation of any clawback obligation). Conversely, private fund advisers would generally
prefer that the carried interest rate be higher or that it not be subject to a preferred return threshold.
For a private fund to be formed, the parties must compromise on economic terms. Part of the
typical compromise by private equity fund investors is to accept a tax liability floor to carried
interest distributions (both in the calculation of annual distributions and in the calculation of any
clawback obligation). This compromise reflects an acceptance that the investor’s share of private
equity fund profits does not include an amount equal to the private equity fund adviser’s assumed
carried interest tax liability. The proposal to prohibit tax limits on clawback obligations appears
intended not to protect investors’ share of fund profits but rather to place a thumb on the

allocations resulting in an assumed tax liability of $350, but due to later year losses, cumulative profits in the private
fund were only $4,000 (20 percent of which is $800).

In this fact pattern, the sponsor is typically obligated to return the entire $200 excess carry amount. The clawback
limitation would apply only to the extent the clawback obligation would exceed $650 and, absent the limitation,
would leave the sponsor with less than the $350 assumed tax liability amount.
negotiation scale to increase investors’ share of fund profits in the clawback fact pattern, calls into question the Commission’s authority to mandate the allocation of profits between private fund investors and advisers, and is objectionable as a matter of principle. We urge the Commission to withdraw this portion of the Proposal in its entirety.

d. Fee and Expense Allocations

Proposed Rule 211(h)(2)-1(a)(6) would prohibit an adviser from directly or indirectly charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) or allocating fees and expenses on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment. We oppose prohibiting such allocations and instead offer an alternative we believe would achieve the Commission’s objectives while allowing advisers to consider what is in each of their clients’ best interest.

As an initial matter, we believe the Commission is correct to focus its scrutiny on instances where multiple private fund clients have invested or propose to invest in the same portfolio investment. In certain circumstances, private fund advisers would have difficulty, due to timing considerations, lack of governing or negotiating authority and other reasons, to impose a requirement to bear expenses on a non-client, such as a transactional counterparty, lender, co-investor, or other third party. In this vein, we commend the Proposal’s recognition that potential co-investors that have not executed a binding agreement to participate in a transaction through a co-investment vehicle (or another fund) managed by the adviser do not need to bear a pro rata portion of “broken-deal” or other fees and expenses.31

However, we remain concerned in that the Proposal does not recognize circumstances where allocating on an other-than-pro rata basis would be fairer or more equitable to multiple private fund clients, such as in a case where an expense is allocated based on “relative benefit” to private fund clients. By way of example, there are frequently circumstances where private fund advisers sponsor multiple funds that are permitted to make investments, such as where one private fund is nearing the end of its investment period and another private fund is just beginning its investment period. If the related private fund adviser retains an investment due diligence service for the benefit of its private funds, a 50-50 pro rata allocation would comply with proposed Rule 211(h)(2)-1(a)(6); however, it would disfavor the older fund in that the older fund would bear half of the subscription service costs but (due to the late stage of its investment period) receive less than half of the benefits of the subscription costs. In circumstances like these, thoughtful private fund advisers allocate these expenses on the basis of perceived relative benefit to the private funds, addressing the ability to allocate on this basis, where appropriate, in their expense policies and related investor disclosures. The Proposal would appear to prohibit these practices.

In order to prevent circumstances where compliance with proposed Rule 211(h)(2)-1(a)(6) would produce results that are less fair to private fund investors, such as those described above, we would recommend that, instead of prohibiting certain allocations, the final rule32 provide that:


32 Subject as before to the points made in Sections I and II.a regarding retroactive application of the rules.
each adviser must adopt policies regarding the basis for its allocation of fees and expenses among private funds, which an adviser must believe in good faith are fair and equitable\(^33\) and consistent with its fiduciary duties to each affected private fund;

- the policies (or a summary thereof, prepared under the Commission’s full and fair disclosure standard)\(^34\) must be disclosed to investors; and

- in the absence of specific provisions in an adviser’s policies and disclosures to the contrary, all expense allocations among private fund clients must be made pro rata. In doing so, the Commission would be able to address its cited concern that an “an adviser may unfairly allocate fees and expenses to benefit certain favored clients at the expense of others, indirectly benefiting the adviser.”\(^35\)

In response to the Commission’s additional question regarding potential fund governance conditions,\(^36\) we believe that if the final rule includes a prohibition relating to allocations, the rule or related Commission guidance should except from the prohibition circumstances where an adviser determines that it is fair and equitable for its private funds to bear expenses on an other-than-pro rata basis and the private funds’ investors agree. This would enable a private fund’s investors to agree to non-pro rata allocations in limited and appropriate circumstances, while preventing the undue favoritism at the heart of the Commission’s concern.

The Commission has also asked whether the rule should define “pro rata.” We do not believe such a definition is necessary, and that a standard mathematical interpretation will suffice. In light of the multiple methods by which pro rata allocations may be made – e.g., by number of involved private fund clients, by involved private fund clients’ respective assets, by the amount proposed to be invested by each involved private fund, or (with respect to private fund investor services) by the number of investors in each private fund – we do not believe the Commission should mandate a method by which pro rata allocations should be calculated, nor should it require that the same method be used at all times and in all circumstances among an adviser’s private funds. Flexibility in these matters is necessary for an adviser to fulfill its fiduciary duties to each involved private fund client, and a one-size-fits-all regulatory approach with respect to these allocations cannot fairly and equitably address all circumstances at all times.

Finally, the Commission has appropriately noted that “where multiple funds invest in the same portfolio investment at different times, the first fund to invest may initially bear a higher level of fees and expenses than later funds,” and asks further if the proposed rule should address

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\(^33\) In proposing a “fair and equitable” standard, we are affirmatively responding to the Commission’s question whether permitting advisers to allocate in a fair and equitable manner would better achieve its policy goals. See Proposal at 16926.

\(^34\) See, e.g., Fiduciary Interpretation at 33761.

\(^35\) Proposal at 16889.

\(^36\) Proposal at 16926 (“Should there be an exception to the prohibition where an adviser determines that it is in a private fund’s best interest to bear more expenses than another managed vehicle and the private fund’s investors agree?”).
fee and expense allocations among funds that invest at different times. The proposed rule should not include any prescriptive requirements as to fee and expense allocations among funds that invest at different times or in different manners, due to the potential unfairness inherent in such mandates, and the fact that no mandate can contemplate all allocation scenarios that arise in private funds, now or in the future. The importance of a principles-based approach is made obvious in the following scenarios:

- private fund 1 makes an equity investment in a portfolio investment that is an operating company, but due to lack of available capital a later follow-on investment in the operating company must be made by private fund 2. In these circumstances, private fund 1 investors (lacking capital to make the follow-on investment, and thus ineligible to receive potential profits from it) would not expect to pay any portion of private fund 2’s expenses in making the follow-on investment, and would be disadvantaged by doing so. Similarly, private fund 2 investors, not having received any profits from private fund 1’s investment, would not expect to bear any portion of private fund 1’s expenses from the original investment;

- in similar circumstances to the paragraph above, private fund 1 makes a $10MM equity investment in a portfolio investment that is an operating company, with $500,000 in transaction-related expenses, and private fund 2 makes a later $1MM investment in the operating company, with $50,000 in transaction-related expenses. In this scenario, the disproportionate investment size between the $10MM equity investment and the $1MM credit investment would mean that a pro rata allocation of private fund 1 expenses to private fund 2 would roughly double the cost of private fund 2’s investment, likely making it prohibitive; and

- an adviser’s private equity fund makes an equity investment in a portfolio investment that is an operating company, and the adviser’s private debt fund makes a later investment in the operating company’s debt. In these circumstances, the debt fund investors would not expect to bear any portion of the equity investment expenses, and vice versa.

In any of these circumstances, a one-size-fits-all approach in these matters or other scenarios has the potential to cause investors to bear expenses that they did not expect in connection with their initial investment, as well as work to investors’ detriment. In practice, thoughtful private fund advisers frequently must bring these scenarios (and other scenarios where multiple funds invest) to each respective private fund’s limited partner advisory committee, because even detailed disclosures provided at the outset of a fund’s life cannot contemplate all commercial situations and potential conflicts that may arise during the course of its operations. Due to the many variations that are possible, any expense allocation prohibitions the Commission determines to adopt would have to be based on a “same investment, same time, same terms” basis. Any other expense-related circumstances would need to be assessed – and if appropriate enforced – by the Commission based on a private fund sponsor’s fulfillment of its fiduciary duties to each of its affected private funds, rather than an overly-formulaic rule that lacks grounding in the typical structuring of private funds.

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37 Proposal at 16926-16927.
e. Prohibited Fees and Expenses

Proposed Rules 211(h)(2)-1(a)(1) through (3) would prevent an adviser from charging certain specified fees or expenses to its private funds. We address each in turn below.

1. Fees for Unperformed Services. Proposed Rule 211(h)(2)-1(a)(1) would prohibit an adviser from charging any portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment. We understand the Commission’s concerns regarding an adviser’s ability to receive payments relating to services that were never to be performed and are thus not bona fide. We also commend the Commission for noting in the Proposal that:

the prohibited activities rule would not prohibit an adviser from receiving payment for services actually provided. The proposed rule also would not prohibit an adviser from receiving payments in advance for services that it reasonably expects to provide to the portfolio investment in the future.\(^{38}\)

However, we have certain remaining concerns, in addition to those raised in Sections I and II.a above. First, we believe that the Commission should make clear that retainer and similar arrangements where upfront fees are paid in order to have a service provider “on call” to provide particular services can be viewed as services that the adviser “reasonably expects to provide to the portfolio investment in the future.” For example, if an information technology (IT) specialist in an investment adviser’s affiliated operations group contracts to provide emergency IT support services as needed in exchange for a periodic fee, those fees should not be subject to the rule’s prohibitions in the event that no emergency IT support situations actually arise during the relevant period. Essentially, because the specialist agrees to remain “on call” in exchange for the retainer, those services should be deemed “reasonably expects to provide” services rather than prohibited “unperformed” services under the final rule. If these clarifications are not made, we expect that private fund advisers will be incentivized to make use of third parties for all retainer-type arrangements, even if the related services could be provided at a lower cost and more efficiently by the adviser or an affiliate, increasing costs to private fund investors.

Second, we note that the Proposal also includes the following useful carveout from the rule’s prohibitions:

We also do not intend to prohibit an arrangement where the adviser shifts 100% of the economic benefit of any portfolio investment fee to the private fund investors, whether through an offset, rebate, or otherwise.\(^{39}\)

The Commission rightly notes that certain tax-sensitive investors often waive the right to receive their share of any rebates of portfolio investment fees, and asks how the rule should take into account such waivers, if at all. Although we recognize that the Commission presumably

\(^{38}\) Proposal at 16921.

\(^{39}\) Proposal at 16922.
wishes to keep narrow any exceptions to the rule’s prohibitions, we do not believe that the presence of waivers should affect the availability of the 100 percent economic benefit carveout, as individual investors’ tax status and preferences regarding receipt of these amounts are outside of the adviser’s control. Subject to the concerns raised in Sections I and II.a above, we recommend that if the rule is adopted, the Commission permit a carveout to the rule’s prohibitions in circumstances where the relevant private fund offers a 100 percent offset, regardless of tax waiver status.

2. Examination or Investigation Fees and Expenses. Proposed Rule 211(h)(2)-1(a)(2) would prohibit a private fund adviser from charging the private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by “any governmental or regulatory authority,” including the Commission. We understand the Commission’s distaste for investment advisers charging the defense costs for Commission examinations or enforcement inquiries related to the adviser to private fund investors, and in particular its objection to charging amounts relating to adviser settlements or fines to private fund investors. We agree with the Commission’s statement that this aspect of the proposed prohibited activities rule would not cause a dramatic change in practice for most private fund advisers.40

However, the prohibition as worded appears to capture certain scenarios not contemplated by the Proposal, and for which we believe a private fund adviser would be justified in charging examination or investigation expenses as they relate to other governmental or regulatory authorities, as long as full and fair disclosures are made in the relevant Governing Documents and the expenses are appropriately allocated among an adviser’s private funds. By way of example:

- **Fund examinations or investigations that link to the adviser and its related persons.** Certain examinations or investigations related to the offering or the operations of a private fund should be chargeable to that fund. For example, a state or non-U.S. jurisdiction’s inquiry into a private fund’s securities offering in its jurisdiction may extend to the adviser and its related persons, to the extent the adviser’s personnel are listed as “Related Persons” or an affiliated broker-dealer is listed under “Sales Compensation” in the private fund’s Form D or similar filings. These expenses (if appropriately disclosed) should be chargeable to a private fund because they relate to the offering of the private fund, just as do the costs of fund regulatory filings (e.g., Form D) cited permissibly by the Commission.41

- **Portfolio company examinations or investigations that link to the adviser and its related persons.** Similarly, the rule should permit appropriately disclosed expenses incurred in defending a governmental or regulatory authority’s examination or investigation of a portfolio company that relate to activities of the portfolio company. For example, where the examination or investigation of the portfolio company extends to the conduct of an adviser or its related persons, those costs should be chargeable to the private fund. A typical scenario would involve a state licensing board’s investigation of a portfolio company licensing application that extends to that portfolio company’s directors. Because private equity firms, in

40 Id.

41 Id.
particular, routinely appoint related persons of the adviser to serve as portfolio company directors, responding to and defending portfolio company investigations should be chargeable to private funds that include appropriate disclosures.

We would urge the Commission to account for these nuances, as well as the concerns raised in Sections I and II.a above, in considering any final requirements for adoption.

3. Adviser Compliance Expenses. Proposed Rule 211(h)(2)-1(a)(3) would prohibit a private fund adviser from charging the private fund for any regulatory or compliance fees or expenses of the adviser or its related persons. The Commission correctly notes that “this aspect of the proposed rule would likely require advisers that pass on the types of fees and expenses we propose to prohibit to re-structure their fee and expense model.” However, should the Commission attempt to apply the prohibition to pre-existing private funds, the difficulties noted in Section 1.c above would be felt acutely in this area, and we are concerned that private fund advisers in many cases would not be able to “re-structure” a pass-through expense model, but would be forced to wind down affected private funds, due to the difficulties in amending Governing Documents of funds that are already in operation. Any pause in operations to amend Governing Documents or re-open investor negotiations relating to various provisions could cause private funds to miss out on investment opportunities and incur losses. As a result, the Commission should clarify that pass-through arrangements that are agreed to with limited partners with respect to funds that were created before the Compliance Date are excluded from any prohibition in the adopted final rules, particularly in the case of overhead expenses (such as registration with the Commission) for first-time, closed-end fund managers.

In addition, we are concerned that the current formulation of the prohibition could capture situations in which compliance expenses are appropriately charged to a private fund, provided that they are properly disclosed and allocated. We stand ready to help the Commission identify such situations and more effectively tailor the rule.

f. Borrowing

Proposed Rule 211(h)(2)-1(a)(7) would prohibit a private fund adviser from borrowing money, securities, or other private fund assets, or receiving a loan or an extension of credit, from a private fund client. Although we understand the potential for abuses in this area, there are many ambiguities in the Proposal that, as drafted, have the potential to prohibit acceptable or beneficial practices in private funds. For example:

- many private fund governing documents characterize certain amounts paid or distributed to the general partner as loans, rather than distributions, for tax purposes (e.g., in the case of certain advances to the general partner);
- many closed-end private fund documents permit staged closings in which later investors will bear accrued amounts, including interest and/or interest-like amounts, from the date of first investment by earlier investors. At times, an adviser or its personnel may invest in one of these later closings, bearing such amounts alongside, and in the same manner as, third-party investors; and
- many large financial institutions serve (or have affiliates serving) in multiple roles
in private fund complexes, including: investing as limited partners; providing subscription line, asset-backed or other lending facilities to the relevant private fund; providing mezzanine or other financing to portfolio company investments; investing directly or indirectly in the private fund adviser; providing revolving credit facilities to the adviser; providing lending or finance facilities to the adviser’s personnel; and/or providing seed capital to the fund by the adviser or its related persons. These service provider roles and affiliations currently are the subject of detailed conflicts disclosures in Governing Documents. Although it does not appear to have been the Commission’s intention, in light of the “directly or indirectly” language found in the lead-in language of proposed Rule 211(h)(2)-1(a), certain of these arrangements could be picked up in the rule’s prohibitions.

Any final rule adopted by the Commission should clarify that these practices, where appropriately contemplated by Governing Documents, are not prohibited.

Additionally, National Futures Association (NFA), the self-regulatory organization with jurisdiction over private fund sponsors registered with the CFTC as commodity pool operators and/or commodity trading advisors, has prohibited since 2009 loans from commodity pools to related commodity pool operators under NFA Compliance Rule 2-45, which has broad parallels to the Proposal. However, NFA has outlined in an Interpretive Notice42 certain circumstances in which loans and similar transactions are still permissible notwithstanding the provisions of Rule 2-45. In addition to other scenarios that the Commission may wish to carve out from the rule’s prohibitions, including those we describe above, and to foster regulatory alignment, the Commission may wish to consider the transactions permitted by NFA’s Interpretive Notice in formulating its own guidance.

**g. Preferential Treatment**

In an effort to address specific types of “preferential treatment” that the Commission believes have a material negative effect on private fund investors, proposed Rule 211(h)(2)-3 would impose an outright prohibition on private fund side letters or similar arrangements (Side Letters) that would: (i) permit an investor to redeem its interest in a private fund or in a “substantially similar pool of assets”; or (ii) provide information regarding the portfolio holdings or exposures of the private fund, or of a similar vehicle; in either case, where the adviser reasonably expects the enhanced redemption or information rights to have a material, negative effect on other investors in that private fund or in the similar vehicle. We have concerns both with the substance and the process of these requirements and we believe they should be withdrawn. Failing that, we make recommendations below that we believe would more effectively achieve the Commission’s goals.43


43 We emphasize the point made above regarding the considerable burden and expense that would apply in the case of any retroactive application of the Proposal. This would be particularly acute in the case of Side Letters that must be re-negotiated. We anticipate that private fund investors that have conditioned their investment in a private fund on the receipt of certain Side Letter provisions would object strongly to any Commission rule that would void these previously-negotiated provisions, and take significant time and effort to negotiate non-prohibited alternatives, or other provisions, in response to any required changes.
As discussed in Section I.b, the Commission appears to overlook the fact that private fund Side Letters overwhelmingly are entered into based on investor demand and negotiating power, rather than based on an adviser’s “sales practice,” favoritism, or intended fraudulent conduct, as appears to have been the case in the single 2013 example of fraudulent conduct cited in the Proposal. In proposing restrictions under the banner of “preferential treatment,” the Commission appears to misunderstand the dynamics behind Side Letter requests and the circumstances under which they are accommodated or refused. Enhanced information rights, in particular, generally are viewed as investor-favorable, rather than adviser-favorable. If adopted in its current form, the Proposal’s prohibition would likely result in advisers declining investor Side Letter requests out of an abundance of caution that particular requests could have a material, negative effect on other investors. We understand that, as a matter of practical experience, advisers are already more resistant to granting Side Letter requests in investor negotiations that have taken place since the date of the Proposal.

We also note that Side Letter information rights are overwhelmingly requested by private fund investors to fulfill those investors’ bespoke internal reporting requirements; investment policies; tax approach, tax status or tax filings; internal compliance; rules or regulations of the state, local, or non-U.S. jurisdiction in which the investor is based; internal ESG considerations; or RIC status. The Proposal leaves advisers to weigh the examination and enforcement risks of agreeing to an investor’s request for enhanced reporting for these purposes, which could be deemed, in hindsight, to have had a “material, negative effect” on other investors. In the event the Commission moves forward, the information components of proposed Rule 211(h)(2)-3(a)(2) should not apply to information requests made at the initiative of a private fund investor, and, due to the diverse nature of information requested by private fund investors (including the categories set forth above), should not prescribe or limit the categories of information that an adviser could agree to provide in response.

Additionally, the information components of proposed Rule 211(h)(2)-3(a)(2) should not apply to closed-end private funds because their securities are not redeemable. Where securities are not redeemable, the Commission’s concerns regarding preferential information, and a related right to use that information to redeem from a private fund in order to take advantage of that information, should not apply. Moreover, the Commission already has a body of law under Rule 10b5-2 under the Exchange Act to protect against inappropriate trading by persons subject to confidentiality obligations. Confidentiality obligations on investors are virtually universal under private fund Governing Documents, making this prohibition unnecessary.

We are especially concerned about this prohibition with respect to the “substantially similar pools” aspect of the Proposal, discussed further in the text below. Many private fund investors, as well as investors in other pooled vehicles, rely on customized portfolio holdings disclosure for their own internal reporting, internal compliance monitoring, and managing in-kind transactions. We would expect the Proposal to have a significant impact on these...

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44 Proposal at 16929.

45 Proposal at 16888, n.12.

46 If the potential for insider trading is at the heart of the Commission’s concern in this area, the Commission could amend the proposed rule to carve out from the preferential treatment prohibition circumstances in which an investor receiving portfolio information is subject to an NDA or similar confidentiality obligations under the Side Letter or Governing Documents. We believe that any adopted rule should explicitly state that such information arrangements are not deemed to have a material, negative effect on other investors.
Further, any final version of Rule 211(h)(2)-3(a)(1) adopted by the Commission should clarify that redemptions in the following contexts, which are commonly requested by investors, do not have a “material, adverse effect”:

- where a private fund investor would otherwise exceed a specified ownership threshold with particular tax or regulatory ramifications to the investor or to the private fund (e.g., the 25 percent plan asset limitation under ERISA); or

- automatic redemption rights for the adviser’s failure to comply with particular laws or requirements of interest to the investor (e.g., failing to disclose political contributions or placement agent relationships/activities).

Similarly, the Commission should clarify that redemptions in connection with investor-default remedies set forth in a private fund’s Governing Documents are not covered by the prohibition. While these remedies are designed to limit any adverse effect to the defaulting investor rather than to the fund or other investors, absent clarification, the proposed rule could cause advisers to question whether exercising a contractual default right in Governing Documents could be prohibited by the rule, and this possibility does not appear to have been contemplated by the Commission.

We are also concerned that the proposed inclusion of “substantially similar pool of assets” in the rule is too broad and will negatively impact other clients of advisers that are completely unrelated to the adviser’s private fund clients. For example, the Commission should not regulate an adviser’s relationship with other commingled fund clients or other funds that may be offered to different investor pools than the adviser’s private fund clients. In any event and at most, the Commission should limit this provision to substantially similar private funds.

Proposed Rule 211(h)(2)-3(b)(1) would require advance written disclosures to prospective and current investors of other Side Letter terms. We commend the Commission for not seeking to impose private equity-style “most favored nation” provisions on other kinds of private funds, such as hedge funds, where they are not typically a market requirement in such private funds’ Governing Documents. However, the Commission does not appear to have contemplated the challenges that private fund advisers will have in implementing these requirements for the private fund closing process, in which multiple investors’ subscriptions or commitments are accepted on the same day. It would be immensely difficult for private fund advisers to provide Side Letter provisions to potential investors on a pre-commitment basis, as the Proposal appears to suggest, in real time during fundraising. Potential adverse results would include the following:

- a measurable increase in fund organizational costs, due to the operational burden of producing Side Letters continuously;

- delays and difficulties added to what is already a complex closing process in dealing with multiple investors on each relevant closing date;
• the potential for private fund advisers to be required to share Side Letters with investors even in non-finalized form;

• the potential for investors to discern which Side Letter provisions have been given to which of their fellow investors. Private fund investors historically have had a high degree of confidentiality and sensitivity to disclosing to other investors what Side Letter provisions they have received, and we believe they would perceive this possibility quite unfavorably;

• the potential for earlier-closing investors to be disadvantaged relative to those participating in later closings, as the early investors would only get to see certain rights agreed by their closing, whereas later closings investors would have access to an even larger menu of rights during the fundraise period. This could produce skewed incentives that would delay fundraising efforts and increase costs; and

• a chilling effect on sponsor willingness to agree to Side Letters, disadvantaging private fund investors.

We would recommend that the Commission not adopt these provisions as proposed, or that it re-propose for public comment an alternative disclosure regime that would not impair the capital-raising process for private funds to such a substantial degree.47

III. QUARTERLY STATEMENTS

a. General Considerations

Proposed Rule 211(h)(1)-2 would require a Commission-registered investment adviser to prepare and deliver to its private fund investors a quarterly statement for each private fund within 45 days of the end of each calendar quarter. Under the Proposal, statements must be presented in a standardized format, delivered in addition to (or incorporated in) any negotiated reporting requirements, and include disclosures related to (i) fund fees and expenses, (ii) portfolio investment compensation, and (iii) performance reporting. We understand and are supportive of the Commission’s goal of promoting transparency in the private fund industry. However, we believe the Commission should give further careful consideration prior to adopting the requirements as proposed.

1. Investors already negotiate reporting requirements. As discussed in Sections I and II.a above, the Proposal seeks to change the relationship between investors and advisers to private funds. As noted in those sections, investors and their sophisticated legal counsel do in fact negotiate heavily with advisers with regard to the applicable economic terms of the relationship and associated reporting requirements prior to investing in a private fund. Advisers seek long-term relationships with their private fund investors and have incentives to accommodate providing information requested by investors to the extent reasonable and practicable.

47 Because of the short comment deadline, we have not had enough time to develop a recommendation for an alternative approach.
2. **The costs of proposed Rule 211(h)(1)-2 outweigh the benefits for investors.** The amount of data required and the extensive requirements for how data must be presented under the Proposal are onerous and will significantly increase the cost and operational burden of operating a private fund. As noted above, advisers commonly accommodate different reporting requirements from investors and it is likely that such investors will continue to request the same data in their preferred formats, as they do today. For example, while some investors request and receive reporting of fees and expenses on a template adopted by the Institutional Limited Partners Association (ILPA), many investors require reporting that is “bespoke” and either substituted for, or in addition to, the ILPA template or other methods used, and such additional reporting often differs from one another. As a result, the quarterly reports prescribed by the proposed rule would simply be in addition to current reporting (and not a substitute, given the investors’ specifically negotiated requirements) and can be expected to have limited value to investors while significantly increasing costs. Advisers’ administrative back-office personnel will be required to bear substantial burdens in administering these requirements, and as a result advisers are likely to outsource such activity to a third-party administrator, which generally is a “partnership expense” to be borne by private fund investors. We anticipate that third-party administrators will increase their rates to the extent that the Proposal’s substantial reporting and disclosure provisions are adopted.

3. **Achievable standardization is limited.** The Proposal is limited in the degree of standardization that is achievable, because the types of fees and nomenclature used across varying investment strategies and types of private funds structures will limit the degree to which investors can make direct comparisons across funds, particularly funds managed by other advisers or using other forms of Governing Documents. We agree that increased transparency is an appropriate focus for the Commission; however, as explained below, many of the data points required by the Proposal would not be useful to investors to monitor their investments in a private fund, and we recommend that certain of them be dropped or significantly narrowed to better achieve the Commission’s goals, as proposed requirements and related expenses outweigh the potential benefits for investors receiving such information.

   We also note that the fee and expense disclosure requirements are significantly more prescriptive and detailed than those imposed on RICs and are an example of how the Proposal is blurring the line between registered entities and unregistered private funds that are exempt from substantive regulation under the Investment Company Act.

   In addition, the complexity and burdens associated with producing and delivering the statement will likely present a significant barrier to entry and harm smaller and emerging advisers’ ability to compete, resulting in a less competitive industry and economic harm. Small advisers with few employees would be particularly ill-equipped to manage the increased implementation and administrative burdens,\(^{48}\) which would represent significant shifts from current processes.

4. **The performance disclosure framework is unworkable.** The Commission should recognize the limits of standardizing performance given the wide range of investment strategies employed within a private fund structure. There are variables and nuances to the performance calculations currently in use that make even a degree of standardization unlikely and may only

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\(^{48}\) As discussed in Section I.f. above, most SEC-registered advisers are small businesses by any rational measure and the Proposal does not take the potential impacts on these advisers into account.
serve to confuse investors should they try to compare one strategy to another based on the mandated performance metrics as envisioned. The Commission rightly noted in the recent release related to the new Marketing Rule that “prescribing the calculation [of performance] could unduly limit the ability of advisers to present performance information that they believe would be most relevant and useful.”  

The Proposal’s distinction between illiquid and liquid private funds, in particular, is unworkable because it is overly technical and impractical in its application. The private fund industry simply cannot be divided into retroactively-applied liquid and illiquid fund categories and still provide meaningful disclosure based on such categorization to investors. We are unaware of any industry or investor group using the Commission’s proposed distinction. Further, the proposed framework would require certain private funds to provide an internal rate of return (IRR) when perhaps total returns would be more suitable (and vice versa), and in many cases, a private fund that was marketed with IRR would be required to provide total returns (and vice versa). The proposed framework would result in private fund investor confusion and potential inability to evaluate a private fund’s ongoing performance against its marketing materials. Further, the release recognizes that certain hybrid funds would appropriately meet the definition of a liquid and an illiquid fund over different periods in the course of their life, but the rigid framework does not accommodate or solve for this eventuality.

We recommend that the Commission instead adopt the approach currently used in Form PF Section 1b, Item C, which requires performance to be reported in the manner “as reported to current and prospective investors.” Prior performance is already a near-universal feature of advertising and is already regulated under the new Marketing Rule in a principles-based manner under the anti-fraud provisions of the Advisers Act. Mandating specific performance presentations in quarterly reporting that are different from performance used in marketing material would be burdensome with no incremental investor protection and is likely to be confusing. The potential overlap with the Marketing Rule for performance metrics in addition to the required metrics also will be difficult to manage from a compliance perspective.

Instead of mandating specific types of performance metrics, a final rule should instead require greater transparency from advisers in the form of clear disclosure of material facts and assumptions used in generating the metrics and the effects of those assumptions on the reported performance. This type of clear disclosure to investors will permit them to better understand the adviser’s performance while also appreciating the limits of comparing one private fund adviser returns against one another.

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50 Our recommendation is to abandon the liquid / illiquid framework entirely, although failing that, if the Commission does proceed, we recommend that the definition of “liquid” fund be narrowed so that it only captures funds that offer redemptions in the ordinary course, e.g., through cross reference to the “redeemable securities” definition in Investment Company Act Section 2(a)(32) and related guidance, or otherwise, and not redemptions that are necessary to meet other regulatory requirements that may apply to a particular investor.

51 The Marketing Rule is already in effect, with a compliance date of November 4, 2022.
b.  **Less Burdensome Requirements Can Still Meet the Commission’s Policy Goals**

We believe the Commission’s policy objectives could be met with a more narrowly-tailored quarterly report. Below we outline several specific ways that the Commission can tailor the required components of the quarterly report to remain useful to investors, which will also reduce the cost and time burden on advisers (and indirectly reduce the cost burden that will be passed on to investors):

- with regard to the Fund Table, the final rule could require a limited number of specific fee and expense items that are commonly charged across private fund strategies (such as those currently identified in the Proposal), but then provide advisers with the flexibility to group other fees and expenses into broad categories, such as is permitted in the fee table for RICs;

- instead of requiring a breakout of each covered portfolio investment, which would require multiple unnecessary data points, the final rule should allow for the aggregation of such amounts across all of the covered portfolio investments. This would relay the same information to investors regarding fees and expenses borne by the private fund and minimize the potential for confusion by eliminating lengthy and unnecessary lines of information that investors typically do not want or need (particularly if there is an applicable management fee offset);

- if individual covered portfolio investment reporting is required, the final rule should permit a *de minimis* amount under which reporting would not be required or would be aggregated in a separate category (e.g., “Other Expenses”) because the impact on the investor would be immaterial and detailed reporting would be unnecessary and simply clutter the table. For example, requiring individual covered portfolio investment reporting for investments above five percent of a fund’s net asset value would still provide information to investors but would eliminate overly-granular reporting with respect to relatively smaller investments for which investors would not have as much interest in tracking amounts spent;

- the final rule should eliminate the requirement to disclose fees before offset/rebate/waiver because that approach does not reflect actual investor experience and has the potential to mislead investors into assuming they are paying higher fees than are actually applicable. The requirement to report the offsets or rebates carried forward to subsequent periods is similarly unnecessary and confusing to investors to understand the applicability of such amounts to their individual circumstances;

- the final rule should eliminate the reporting of the private fund’s ownership percentage of each covered portfolio investment. Reporting to investors already typically includes the amount of the fund’s investment in the portfolio company, which is the most relevant piece of information, and providing the ownership percentage is superfluous. Providing ownership percentages in other circumstances may be difficult to provide meaningfully in circumstances where there are multiple classes of equity ownership or where the fund’s investment incudes debt (or non-
participating/non-convertible preferred) components, and may facilitate a reverse
ingengineering of portfolio company enterprise valuations, which are often intended or
required to be kept confidential;

• the final rule should eliminate the requirement to consolidate reporting with
substantially similar pools of assets in light of potential investor confusion, even if
(as would be less burdensome and thus preferable) this requirement were limited to
consolidation with other private funds;

• the cross references to the Governing Documents are similarly unnecessary and will
lead to additional data points with limited utility. Governing Documents generally
contain extensive disclosure regarding permitted fees, expenses, and payments –
particularly after the registration of private fund advisers as a result of Dodd-Frank
and subsequent enforcement actions on the topic – but authorizing language is
generally concentrated in a handful of provisions in the Governing Documents.
Accordingly, this requirement will result in the repetition of cross-references to the
same provision throughout the quarterly report. While this information may not be
difficult for advisers to provide, it will similarly clutter any reporting without
meaningful benefit to the investor and it should be eliminated in the final rule;

• the final rule should require reporting only at the fund level, as proposed, and not
require individual investor reporting, which would add significant costs to any
reporting requirement;

• the final rule should increase the time to produce and deliver reports from 45 to at
least 60 days to permit advisers to enable the collection of data from portfolio
companies;

• additional leeway or exceptions should be granted to fund-of-fund, secondaries, and
similar strategies that require receipt of underlying reports before producing their
own, including additional time and extensions for underlying funds to deliver the
reports “promptly,” if advisers are unable to provide information under the
applicable timeline despite good faith efforts. This is similar to existing guidance
under the Custody Rule. Although the Proposal would permit performance
information to be provided as of the most recent practicable date (which the
Proposal notes generally would be the quarter end prior to the immediately
preceding quarter), this approach generally would require a longer “ramp up”
period before these investment advisers had performance available to show
investors;

• the reporting time period should also be adjusted for the fourth and first quarters to
align with existing SEC rules related to audited financial statement timing;

• because closed-end funds incur significant expenses in the first year while
investments are held at cost, performance reporting should begin after four
quarterly periods of the funds’ operations (instead of two) in order to avoid giving
investors the misleading impression that investments are performing poorly, and
additional time should be granted to funds that have fund-of-fund, secondaries, and similar strategies;

- the final rule should eliminate the requirement to provide breakdowns of gross IRR and multiple of invested cash (MOIC) for the realized portion and the unrealized portion of an illiquid fund because it will increase the data points required without actually providing meaningful information to an investor in a private fund;

- the final rule should eliminate the requirement to provide a statement of contributions and distributions because this information is of limited value to investors and is currently not often requested;

- the final rule should provide an exception from the requirement to deliver quarterly statements to affiliated RICs that are invested in the private fund because this information is already included in fee and expense information delivered to the RIC shareholders; and

- the final rule should eliminate the requirement that performance metrics be presented without the effect of a subscription line because such presentation shows the actual experience of an investor; otherwise the disclosed performance could be characterized as hypothetical. The definition of “fund-level subscription facilities” also is overly broad (by including “or other indebtedness”) and thus raises questions regarding the scope of arrangements it covers, and whether it extends to performance information received from underlying funds.

The Commission has asked a large number of questions in the release about the calculation of performance metrics and certain other compensation practices not addressed in the Proposal. We have not been able to formulate a reasoned response to very many of these, given the short comment period, but the sheer number and complexity of the topics raised may be an indication of the extreme difficulty associated with standardizing performance for a diverse and ever-changing asset class generally. In one instance, however, the Commission asked whether it should step in and establish the maximum fees that advisers can charge their private fund investors or prohibit certain compensation agreements (including commonly-charged levels of management fees and performance compensation specifically provided for in the Advisers Act). This would be misguided, given the ability of sophisticated parties to negotiate the terms of their relationship. And since the Commission gave no indication or detail around how it would structure such fee caps, we would strongly suggest that the Commission could not proceed to adopt any such restrictions without publishing a specific proposal and providing additional time to comment.

In summary, we believe the requirement to provide detailed fund-level and investment-level disclosures would impose substantial costs on private funds and their advisers, costs that will ultimately be borne by fund investors in the form of higher amounts of partnership expenses charged to investors and/or higher fees. The same policy objectives could be achieved with a more narrowly-tailored set of rules that better balances the burdens with the anticipated benefits to investors. We recommend that the Commission not adopt these provisions as proposed, or re-propose an alternative reporting regime with clearer definitions and more discrete obligations, in order to give private fund advisers the ability to provide meaningful comment.
IV. Mandatory Private Fund Adviser Audits

Proposed Rule 206(4)-10 would require a Commission-registered adviser to obtain from an independent public accountant an annual audit of the financial statements of all of its managed or advised funds. As a general matter, we are concerned that the proposed audit requirement effectively attempts to amend the Custody Rule, which we do not believe would be appropriate without an explicit proposal that is put out separately for notice and comment. The IAA has long called for a complete review of the Custody Rule. We are pleased that modernization of that rule is on the Commission’s regulatory agenda and look forward to engaging with the Commission on that proposal.\textsuperscript{52}

In addition, as proposed, the new audit rule would substantially overlap with the requirements of the Custody Rule and be duplicative and likely to cause industry confusion. The Proposal appears to be aimed at advisers that do not procure audits over private funds because they: (i) do not have “custody,” as defined by the Custody Rule; (ii) are located outside the United States and subject to legacy exemptions from the Custody Rule or key Custody Rule requirements; or (iii) procure surprise examinations rather than audits of pooled investment vehicles. The Proposal has not sufficiently identified advisers falling into these categories as a source of the fraudulent conduct at the heart of the Commission’s concern. We believe the Commission also underestimates the impact the Proposal would have on sub-advisers (which due to their role seldom have even the ability to engage in valuation misconduct or misappropriation) and on advisers based outside the United States.\textsuperscript{53}

In order to prevent unnecessary industry confusion and burdens disproportionate to the Commission’s concern, we recommend as follows:

\begin{itemize}
  \item the Commission should not impose a separate rule regarding annual audits, but should amend the Custody Rule to produce the desired effect through a separate rulemaking that reconsiders the Custody Rule holistically. This would also have the benefit of incorporating any new audit requirements the Commission wishes to impose into existing Commission positions and no-action letters it would seek to codify, reducing industry confusion and the need for ongoing interpretation by the Commission’s Staff;
  \item the Commission’s current Custody Rule interpretive positions should remain with respect to all audits to be obtained by registered investment advisers on behalf of their clients, such as that an investment adviser is not required to reconcile a non-U.S. fund’s non-GAAP financial statements to GAAP when distributing such
\end{itemize}

\textsuperscript{52} SEC Regulatory Flexibility Agenda (Fall 2021), available here. See also IAA Letter to Chair Gensler, Regulation of Investment Advisers (May 17, 2021), available at https://investmentadviser.org/resources/regulation-of-investment-advisers/.

\textsuperscript{53} As noted above in Section II.a, the Commission asks on p. 16921 of the Proposal if commenters agree that registered offshore advisers should not be subject to the Proposal’s rulemaking package with respect to their offshore private fund clients or offshore investors. We believe they should not be, particularly with respect to the mandatory private fund audit requirement, for the reasons discussed above.
statements to non-U.S. investors;\textsuperscript{54}

- non-U.S. advisers should continue to be subject to the “regulation lite” approach permitted by existing Staff guidance;\textsuperscript{55}

- if the Commission nonetheless proceeds to consider custody-related issues in this rulemaking, any final rule adopted by the Commission should not require an audit if the custodian delivers quarterly account statements to investors or in circumstances where the cost of procuring the audit is disproportionate to the value of the assets in, or activity level of, the private fund, such as: (i) during any year in which the relevant private fund did not have cash inflows or outflows, \textit{e.g.}, in end-of-fund-life scenarios;\textsuperscript{56} (ii) where the relevant private fund’s assets are under a certain value; or (iii) where the relevant private fund is wholly owned by a single investor and its affiliates or a single family; and

- consistent with the retroactive application considerations discussed in Section 1.c above, we urge the Commission not to require audits of private funds that have been unaudited to date over the course of their operations, as in practical experience audit firms have been unable or unwilling to generate the necessary work papers, dating back to inception, to produce an audit consistent with GAAP.

V. Secondary Transactions

Proposed Rule 211(h)(2)-2 would prohibit registered investment advisers from entering into certain adviser-led secondary transactions unless they obtain and deliver to selling fund investors a third-party fairness opinion regarding the price at which assets are being sold and a summary of any material business relationships between the fairness opinion provider and the adviser or its related persons within the past two years.

As an initial matter, we agree with the Commission’s view that any fairness opinion provider should provide these opinions in the ordinary course of its business, and should not be a related person of the adviser. However, given the cost of fairness opinions in adviser-led secondary transactions, which are generally borne by investors, we would urge the Commission to consider for purposes of the final rule:

- an exemption from the fairness opinion requirement where the price of the subject investment(s) is set by the market, or one or more third party sources unaffiliated with the investment adviser \textit{(e.g.,} where (i) the adviser-led secondary relates to securities with a widely-agreed or market price; (ii) an independent service provider

\textsuperscript{54} Staff Responses to Questions About the Custody Rule, Question VI.5, available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm.

\textsuperscript{55} \textit{E.g.,} http://www.sec.gov/divisions/investment/noaction/aba081006.pdf.

\textsuperscript{56} This could be conditioned on the adviser undertaking in the private fund’s offering documents to deliver unaudited financial statements to the remaining investors in the private fund.
performs a valuation or provides valuation advisory services; or (iii) the bid price is set by one or more unaffiliated buyers, whether through a competitive auction process or otherwise); and

- a *de minimis* exemption from the fairness opinion requirement for smaller private funds with assets under a set value or smaller transaction sizes.

Allowing for these and other similar exemptions would enable the Commission to balance its desire for fair transaction terms against the substantial costs imposed by third-party fairness opinion providers. We also urge the Commission to consider alternatives (e.g., investor approval alternatives) to the extent that fairness opinion providers are unavailable, unable, or unwilling to provide a fairness opinion with respect to certain assets.

**VI. Annual Review of Compliance Policies**

Proposed Rule 206(4)-7(b) would require all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing. We understand the Commission’s concern and note the potential benefit to the Commission’s examination Staff in determining whether a required annual review has been conducted. We also note that a written annual review has been a widely adopted best practice for investment advisers, including private fund advisers, for years. We therefore support this proposed provision.

* * * *
The Proposal raises many important questions that we continue to consider carefully and we look forward to engaging with the Commission and its Staff to provide additional feedback. In the meantime, please do not hesitate to contact the undersigned or IAA Associate General Counsel Monique Botkin at [redacted] if we can be of further assistance.

Respectfully,

/s/ Gail C. Bernstein

Gail C. Bernstein
General Counsel

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