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

Submitted via email to rule-comments@sec.gov

April 25, 2022

Dear Ms. Countryman,

Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (File Number S7-03-22)

The Alternative Investment Management Association Limited ("AIMA")[1] and the Alternative Credit Council ("ACC")[2] appreciate the opportunity to respond to the Securities and Exchange Commission (the "Commission" or "SEC") with respect to the proposed new rules and amendments under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), governing the activities of private fund advisers (such proposed new rules and amendments are collectively referred to herein as the "Proposal").[3]

The Proposal, if adopted in its current form, is certain to fundamentally transform the private fund industry, including in ways that that will have significant unintended and adverse consequences for investors. The Proposing Release does so on the basis of insufficient data (in certain cases, by

1 AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

2 The ACC currently represents over 250 members that manage over $600 billion of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy, providing finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts, and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

3 SEC, Proposing Release, Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 FR 16886 (March 24, 2022) (the "Proposing Release").

its own admission) and with limited analysis of such consequences.[4] Moreover, not only does the Proposing Release fail to adequately consider the costs and benefits of the Proposal, but it is also based on a view of the private fund industry that does not correspond to the reality in which private fund investors are sophisticated, well-advised and capable of representing their own interests. In addition, and as indicated by the industry's extraordinary growth, investors are fundamentally satisfied with the status quo; the Proposal on the other hand unnecessarily risks disrupting such investors' ability to deploy capital on behalf of their ultimate beneficiaries in the manner such investors think best. The Commission is undertaking a significant overhaul of the private fund industry without having conducted a sufficient cost-benefit analysis of the impact on advisers and investors and without having properly considered less burdensome alternatives to achieve its goals. As a result, the Proposal is certain to have significant unintended consequences for all parties.

While we unequivocally support the Commission's goals of investor protection (primarily through disclosure), promoting greater efficiency and competition in the market for private fund investing, and facilitating capital formation, we strongly believe that the Proposal, if implemented unchanged, would be counterproductive to achieving these and other Commission goals. We believe the Proposal would:

1. harm investors through diminished efficiency and competition in the private fund market and the needless imposition of added burdens on investors' ability to deploy capital in private funds;

2. disproportionately harm small advisers, including minority- and women-owned businesses;

3. ultimately increase the costs borne by investors, as well as make it more difficult for investors to receive information specifically tailored to their compliance, portfolio management, ESG goals and/or other requirements; and

4. unnecessarily divert the Commission's resources from the protection of retail investors towards the protection of sophisticated, knowledgeable investors who retain and/or have access to professional advisors in connection with their investments in private funds. These investors already have robust protections under Federal securities laws, including, but certainly not limited to, the non-waivable fiduciary duties that advisers owe to their clients under the Advisers Act, as well as the fundamental anti-fraud provisions of the Advisers Act, the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act").

We recognize the importance of full and fair disclosure to investors, including sophisticated private fund investors who require such information to make their investment decisions. However, we

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

believe that introducing overly prescriptive reporting requirements and categorical prohibitions on activities is not the optimal approach to protecting private fund investors. In fact, we believe that such an approach will ultimately result in less comparable and useful disclosure and other adverse consequences for investors. **We would therefore urge the Commission to pause this rulemaking process and instead to engage with private fund advisers and investors to gather additional information regarding the likely consequences and related costs and benefits of the proposed rules and, ultimately, to consider a more flexible, principles-based approach, emphasizing disclosure, following that research effort.** The Commission has recent experience in doing so, having adopted new rules governing investment adviser marketing in 2021 following a year-long process of careful, thorough engagement with stakeholders.[5] In the Marketing Rule, the Commission provided advisers with a flexible, principles-based framework to assess when their advertisements may be misleading, rather than adopting highly prescriptive requirements and blanket prohibitions. We would strongly urge the Commission to take a similar approach in relation to the Proposal, particularly given that, unlike the Marketing Rule, the Proposal is aimed only at the most sophisticated investors who, in many cases, have *already* made the decision to invest in a private fund. A process of stakeholder engagement would allow the Commission to better determine whether problems exist in the private fund industry to such an extent that regulatory, rather than market, solutions are required. As we discuss further below, the Proposing Release does not provide satisfactory evidence that this is in fact the case.[6]

There is little question that the Proposal would significantly disrupt ongoing private fund operations, both due to the failure to provide for grandfathering with respect to existing arrangements between private fund advisers and investors (particularly with respect to proposed Rule 211(h)(2)–1 (the "Prohibited Activities Rule") and proposed Rule 211(h)(2)–3 (the "Preferential Treatment Rule")) and, for new and/or open funds, due to the fact that these rules would discourage or outright prohibit ordinary course investor-favorable terms and practices. The agreements between private fund investors and advisers reflect thoughtful consideration of costs, benefits, alignment of interests and the allocation of risk to strike a balance that ultimately benefits investors. By deeming certain practices embedded in the terms of these agreements to be *per se* unlawful, the Proposal will materially upset the relationship between advisers and investors built over many years in an iterative process of negotiation and compromise. The Proposing Release fails to adequately consider the consequences of upsetting such balance and, in particular, the ways in which investors will be harmed as a result. Accordingly, we urge the Commission to withdraw these rules, including the prohibited activities and preferential treatment rules, pending further study and engagement with both investors and advisers regarding their consequences. If the Commission nevertheless elects to adopt these rules without such study, then it must address

5 SEC, Final Rule, Investment Adviser Marketing, 86 FR 13024 (March 5, 2021) (the "Marketing Rule").

6 We acknowledge that some groups of investors have sought the Commission's involvement in this area, but certainly not to the extent contemplated by the Proposal. We are disturbed that the Commission has apparently based its rulemaking on such groups' preferences and that it has done so on the basis of only limited analysis and without conducting an in-depth research effort that solicits input from all stakeholders. The private fund market is characterized by arm's-length bargaining between fund advisers and investors. As is normal in such situations, the resulting equilibrium is one in which neither side gets all that it wants. However, many investors prefer structures and approaches that would be prohibited by the proposals. Finally, we would emphasize that the industry has had limited time to consider the Proposal, and additional concerns are therefore likely to surface once the many adverse and unintended consequences to investors of the Proposal become clear.

the risks of significant disruption that are likely to result, including by clarifying and/or limiting certain aspects of the rules and by providing for appropriate grandfathering and transition periods with respect to existing fund arrangements.

We also question the legal basis upon which the Commission has asserted its authority to promulgate many of the new rules included in the Proposal. The provisions of the Advisers Act cited as authority for the new rules were never intended to extend the authority of the Commission over private funds and private fund advisers in the manner contemplated in the Proposal. The Commission has historically relied on a regime of disclosure and consent with respect to private funds and advisers, in recognition of the fact that (i) private fund investors do not need the full scope of protections afforded to retail investors under the Advisers Act, and (ii) the Commission's resources should not be allocated away from retail investors to sophisticated investors that are better able to advocate for themselves in negotiations with fund advisers. In this Proposal, however, the Commission not only imposes substantial requirements on private fund advisers that in certain cases go beyond the requirements applicable to advisers to funds with primarily retail investors (specifically, mutual funds governed by the Investment Company Act of 1940, as amended (the "Investment Company Act")), but also directly imposes its preferences on, and interferes with, negotiated agreements between sophisticated consenting parties.

Additionally, we would reiterate the concerns expressed in the April 5, 2022, letter to Chair Gensler that we submitted along with several other trade associations regarding "Importance of Appropriate Length of Comment Periods," including with respect to the insufficient time provided for meaningful economic analysis of the effects of the Proposal and the number and breadth of other proposed rules that the industry must evaluate and address concurrently.[7] The Commission's recent rulemaking process has given the industry insufficient time to fully assess the impact (both individually and collectively) of such proposals and thoughtfully consider less burdensome alternatives.

Finally, we affirm our full support for the recommendations with respect to collateralized loan obligations made by the Loan Syndications and Trading Association in its April 25, 2022, comment letter to the Commission in response to the Proposal.

We have summarized a few of our primary concerns and key recommendations regarding the Proposal below and address each aspect of the Proposal in greater detail through our responses to a number of questions raised by the Commission in the attached Annex.

General comments

- The Commission developed the Proposal without sufficient consideration of the sophistication of private fund investors, their ability to bargain for favorable terms, their actual practice of engaging in such bargaining extensively, and the negative outcomes to investors that would result if these reforms were adopted as proposed. The broad scope and one-size-fits-all

[7] Moreover, the proposals are not considered in a vacuum. In many cases, the personnel at advisers to private funds who are charged with responding to these proposals are the same personnel currently having to deal with such matters as the impact of sanctions related to the Russia/Ukraine war, for example.

nature of the Proposal disempowers investors by taking away their ability to set their own priorities in order to meet their individualized needs.

- The Proposal would impose substantial burdens on all advisers, but would, in particular, disproportionately impact new and small advisory firms, a higher proportion of which are women- and minority-owned. Such firms may have less capacity to absorb the considerable new costs of complying with the requirements. Higher barriers to entry will mean greater industry consolidation and less choice (and thus ultimately higher costs) for investors.

- The Commission has not conducted an appropriate cost-benefit analysis of the Proposal and is frequently unable to quantify the expected benefits or costs to investors, or otherwise asserts benefits without supporting evidence. Furthermore, the Commission repeatedly neglects to consider less burdensome and costly alternatives that could meet its stated policy goals.

- The Commission should follow its long-standing position that the substantive provisions of the Advisers Act should not apply to non-U.S. registered advisers with respect to their offshore funds, exempt reporting advisers and foreign private advisers. Imposing these requirements (as applicable) on these advisers would incentivize them to avoid the U.S. market and lead to fewer options for U.S. investors.

- With respect to the Prohibited Activities and Preferential Treatment Rule, the Commission should withdraw these proposals in their entirety pending further study. However, if it declines to do so, it should explicitly provide for grandfathering as described in our response to Question 269.

Quarterly Statement Rule (Proposed Rule 211(h)(1)–2)

- Proposed Rule 211(h)(1)-2 (the “Quarterly Statement Rule”) is unnecessary and duplicative, as most advisory firms already provide sufficient reporting and investors are generally able to negotiate for and receive disclosure appropriate for their particular needs. The Commission did not attempt to assess current reporting to determine the extent to which it overlaps with the proposed requirements or is otherwise inadequate to provide investors with the information they need to properly evaluate their investment.

- If the Commission adopts the rule, it should:

    - align the performance reporting standards with the principles-based approach reflected in the Marketing Rule; and

    - only require that statements be furnished on a semi-annual basis, which is the frequency with which mutual fund shareholders are required to receive statements and should allow advisers to align them with audited financials in order to ensure consistency across the reports that investors will receive.

Mandatory Audit Rule (Proposed Rule 206(4)–10)

- Proposed Rule 206(4)-10 (the "Mandatory Audit Rule") effectively eliminates the surprise examination option under Rule 206(4)-2 under the Advisers Act (the "Custody Rule") for private fund advisers without evidence that surprise examinations have not sufficiently protected private fund investors.
- The Mandatory Audit Rule would be particularly burdensome for non-U.S. private fund advisers, particularly for advisers not previously required to perform a U.S. GAAS audit and in jurisdictions where there are a limited number of auditors that can meet the requisite independence requirements with respect to a given fund. These requirements would impose substantial costs on advisers without any obvious new benefit to investors.
- If the Commission adopts the rule, it should consider less burdensome alternatives, such as harmonizing the rule with the Custody Rule or explicitly providing that compliance with one rule would satisfy the requirements of the other, in order to avoid duplicative and costly audit requirements.

Adviser-led Secondaries Rule (Proposed Rule 211(h)(2)–2)

- Adviser-led secondary transactions benefit both the private fund and its investors and are often initiated by investors to provide them a mechanism to obtain liquidity.
- As proposed, requiring a fairness opinion in connection with each such transaction is likely to be costly and may disincentivize such transactions to the detriment of investors.
- We recommend the Commission broaden the range of options for advisers to include independent valuations and assurance reviews. Both offer a similar level of investor protection but at materially lower cost/effort to the adviser (and ultimately to investors).

Prohibited Activities Rule (Proposed Rule 211(h)(2)–1)

- It is not clear to us why the Commission does not consider full disclosure of, and investor consent to, these activities to be a sufficient approach to protect sophisticated investors. The Commission has historically penalized advisers for failures of disclosure but has never once suggested that these activities are *per se* unlawful. The Commission should not interfere in contractual relationships between sophisticated, consenting parties. Many investors view these terms as essential tradeoffs in order to maximize their returns and receive the full benefit of their bargain.
- The Commission's prohibition on limiting liability for breach of duty, willful misfeasance, bad faith, negligence and recklessness ignores decades of standard industry practice and imposes a greater standard on private fund advisers with respect to private fund investors than on registered fund advisers with respect to retail investors. This is likely to have consequential impacts on existing commercial relationships and lead to negative consequences well beyond what the Commission likely intended.

- In prohibiting an adviser from charging the fund for certain fees and expenses, the Commission admits that such changes would likely lead to an increase in management fees (or the imposition of a management fee if one did not previously exist). It is not obvious how this would be a preferential outcome for investors, particularly investors in a fund that uses a pass-through model, who now will have less visibility into specific fees and expenses and who will be subject to a re-structured fee model different from what they had originally bargained for. The Commission should withdraw the fee and expense provisions in their entirety. If the Commission nevertheless adopts the rule, it should, at a minimum:

  - permit a principles-based approach which would allow advisers to determine the appropriate characterization of fees and expenses (and make proper disclosure to investors);

  - clarify that expenses associated with the statements required under the Quarterly Statement Rule, the audits required under the Mandatory Audit Rule, the fairness opinions under proposed Rule 211(h)(2)–2 (the "Adviser-Led Secondaries Rule"), the notification obligations under the Preferential Treatment Rule and books and records rule, and any costs incurred by advisers in connection with their initial compliance with the Proposal more generally (e.g., the costs of amending fund documentation and agreements with investors) could be appropriately treated as fund expenses, rather than adviser expenses;

  - clarify that fees or expenses associated with governmental or regulatory authority examinations or investigations that relate to the private fund's investment strategy may be charged to the fund without violating the prohibition; and

  - provide a full exception for advisers utilizing a pass-through expense model.

Preferential Treatment Rule (Proposed Rule 211(h)(2)–3)

- The Preferential Treatment Rule will significantly disrupt existing commercial arrangements and, as proposed, could lead to disastrous consequences for funds and investors, despite the fact that preferential treatment often advantages investors. The rule may, for example, incentivize larger private fund investors to allocate their capital away from private funds and into other types of investments for which they are able to secure preferred terms, which would make it more difficult for new funds to receive seed and early-stage capital, and, in the case of existing open-end funds, could lead to redemptions on such a scale that the ability of the fund to continue to operate is materially impacted. Furthermore, certain advisers may opt to no longer offer investors the ability to enter into side letters.

- The Preferential Treatment Rule will chill communications between advisers and investors and limit their ability to receive personalized, favorable terms. As the Commission noted in the Marketing Rule, it excluded one-on-one communications from the Marketing Rule "to avoid the possibility that the rule would impede typical communications between advisers and their existing and prospective investors" as "[a]n adviser might have been dis-incentivized to communicate regularly with its investors if it believed it would have to analyze every communication for compliance with the proposed rule.”[8]

- The Commission should withdraw this rule pending further study. If it declines to do so, the Commission should revisit its definition of "substantially similar pool of assets," which we believe is overbroad and, in this context, is likely to result in investors being subject to unreasonable limitations on liquidity and informational rights as a result of an over-aggregation of vehicles for purposes of compliance by certain advisers. If this requirement is not withdrawn, it should be restricted to non-retail pools of assets designed to invest *pari passu* with the private fund.

- In addition, the Commission must clarify the meaning of the phrase “reasonably expects to have a material, negative effect on other investors.” As it stands, such standard is vague and open to substantial uncertainty, which will result in needless harm to investors.

We would be happy to elaborate further on any of the points raised in this letter. For further information please contact Jennifer Wood, Managing Director, Global Head of Asset Management Regulation & Sound Practices at jwood@aima.org.

Yours sincerely,

Jiří Król
Deputy CEO, Global Head of Government Affairs, AIMA
Global Head of the ACC

Cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Allison Herren Lee, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
Mr. William Birdthistle, Director of the Division of Investment Management
Mr. Dan Berkovitz, General Counsel

[8] Marketing Rule, *supra* note 5, at 13030.

ANNEX

In this Annex, we first raise a number of overarching thematic concerns with respect to the Proposal and then move on to provide responses to a number of the specific questions raised by the Commission in the Proposing Release. **For ease of reference, we have retained the original order in which questions appeared in the Proposing Release but have omitted the questions to which we have chosen not to respond. For the avoidance of doubt, our decision not to respond to a particular question should not be taken as an indication that we agree or disagree with any of the suggestions made by the Commission therein**.

I. The Commission's stated justifications for the Proposal do not properly account for the level of sophistication of private fund investors.

The Commission broadly seeks to justify the Proposal on the basis that:

> "Private funds and their advisers also play an increasingly important role in the lives of ***everyday Americans*** saving for retirement or college tuition. Some of the largest groups of private fund investors include state and municipal pension plans, college and university endowments, non-profit organizations, and high net worth individuals. Numerous investors also have indirect exposure to private funds through private pension plans, endowments, feeder funds established by banks and other financial institutions, foundations, and certain other retirement plans." (emphasis added).[9]

While the Commission's reference to "everyday Americans" implies a direct relationship between private fund advisers and retail investors, the private funds market operates quite differently in practice. As the Commission notes immediately thereafter, to the extent retail investors have exposure to private funds, it is *indirectly* through institutions (pension plans, nonprofit and university endowments, foundations, etc.) that are themselves the direct investors in private funds. Private fund investors are typically among the most sophisticated parties in the world, and they employ sophisticated in-house investment staff and regularly engage investment advisers, professional consultants and qualified internal and external legal counsel to assist them in identifying, vetting and negotiating their investment agreements. These investors negotiate with advisers to craft a commercial relationship that is best suited to their particular needs and tolerances, and private fund agreements reflect an informed and careful balancing of costs, benefits, alignment of interest and the allocation of risk, developed over time through an iterative process of negotiation and compromise between sophisticated parties. The Proposal would unnecessarily interfere with these relationships by imposing arbitrary, one-size-fits-all requirements on advisory relationships and divesting sophisticated institutional investors of the discretion to enter into commercial relationships on terms of their choosing.

The Commission argues that a lack of transparency regarding costs, performance and preferential terms causes an information imbalance between advisers and private fund investors such that bilateral negotiations are ineffective in remedying what the Commission perceives as

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[9] Proposing Release, *supra* note 3, at 16887.

shortcomings in the private fund market. Enhanced information would supposedly, among other things, "help investors better understand marketplace dynamics".[10] Certainly, in the context of the retail market, this might be an accurate statement of the dynamic at issue in one-on-one negotiations. Yet it is hard to argue that a pension plan, university endowment or sovereign wealth fund (or, for that matter, an ultra-high net worth individual) with hundreds of millions (or billions) of dollars in private fund investments needs assistance from the Commission in negotiating or understanding private fund economics, performance and terms (especially since such investors are often negotiating with their private fund advisers at the same time as other prospective investors, thus effectively increasing their collective negotiating leverage). These investors are usually invested in multiple private funds managed by different advisers with different investment strategies.[11] Through their advisory relationships, they have developed a comprehensive understanding of their needs as private fund investors and are counseled by persons with a similar level of sophistication.

Throughout the Proposing Release, the Commission fails to provide evidence that the sophisticated investors who engage in private fund investing lack sufficient expertise or bargaining power to negotiate contracts that adequately protect their interests. For example, the Commission's clawback proposal is based on the unsubstantiated premise that investors have sufficient leverage to demand an adviser clawback, but not enough to require that it not be reduced for taxes.[12] While the Commission expresses the view that private fund investors are ostensibly not sophisticated enough to be able to effectively assess and compare advisers and private funds with the information that they are now provided, it assumes that, once they have access to the information required by the Commission, such investors will invest substantial time and resources to cross-check quarterly statements against the limited partnership agreement or other fund disclosure documents and compile fee, expense and performance data for comparison across their various fund investments.

Our members instead find that private fund investors, and the professional advisors they employ, do in fact engage in lengthy, rigorous and detailed due diligence and negotiation before investing.[13] Such investors frequently demand—and receive—ongoing reporting on returns, costs, investment outcomes and other matters that enables them to carefully monitor their investments and, in open-end funds, to decide whether to remain invested or redeem. Notwithstanding the Commission's apparent belief to the contrary, the terms embodied in private fund contracts reflect an informed and careful balancing of relevant costs, benefits and allocations of risk that have developed over time through vigorous negotiation by sophisticated parties. The proposed rules would upend this balance, inevitably resulting in a myriad of unintended, unpredictable and

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10 Proposing Release, *supra* note 3, at 16889.

11 *See*, *e.g.*, Preqin Special Report: The Private Equity Top 100 (February 2017). According to the Previn report, of the top 20 global allocators to private equity, eight were U.S. (public and private) pension funds. Furthermore, 43% of the top 100 allocators were public pension plans.

12 Similarly, the Commission concedes that the benefits of this prohibition "may be diminished", e.g., if advisers are able to increase their fees, but again without offering substantiating evidence or analysis it boldly predicts that this "would likely be limited." Proposing Release, *supra* note 3, at 16951.

13 *See* Mark S. Rzepczynski and Keith Black, Alternative Investment Due Diligence: A Survey on Key Drivers for Manager Selection, The Journal of Alternative Investments Due Diligence 2022.

adverse consequences for investors as the market responds to this unasked-for, and unwelcome, intervention.[14]

It is difficult to argue that private fund investors, the vast majority of whom are subject to the very high "qualified purchaser" standard under Section 3(c)(7) of the Investment Company Act,[15] need the additional protections under the Advisers Act contained in the Proposal. In fact, the Senate Banking Committee report on one of the bills that ultimately became the National Securities Markets Improvement Act of 1996 (which added the qualified purchaser standard and created the Section 3(c)(7) exclusion) commented that:

> "The qualified purchaser pool reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections. *Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.*" (emphasis added)[16]

With respect to the Prohibited Activities Rule and Preferential Treatment Rule in particular, the Commission does not provide any meaningful analysis of why the traditional approach of disclosure and consent—the approach provided by Congress—is insufficient to protect such investors.

The Commission also cites to a small number of enforcement actions as justification for the Proposal.[17] However, many of the cited enforcement actions relate to an alleged (not established) failure to disclose, which we would expect in a regulatory regime primarily focused on disclosure and in which private fund advisers, like all market participants, are subject to the antifraud provisions of the Federal securities laws (in addition to disclosure obligations under Section 206(4) of the Advisers Act). Furthermore, the Commission offers no indication that there have been continual violations by advisers, particularly in recent years (indeed many of the cited enforcement actions are several years old) that might have moved the Commission to propose the prohibitions and other substantive requirements on private fund advisers in the Proposal. Where there have been failures on the part of investment advisers, the Commission has brought actions and enforced the existing rules – so no apparent regulatory gap preventing enforcement activity in these areas seems to exist. For many years, the Commission's enforcement staff focused on investment advisers to private funds that had a greater impact on retail investors (such as where

14 *See, e.g.,* Rat Farms and Rule Comments – Statement on Comment Period Lengths (Commissioner Peirce).

15 *See* High-End Bargaining Problems, Vanderbilt Law Review (forthcoming), Professor William Clayton (Jan. 8, 2022) at 19 (noting that "Various other exemptions to the Investment Company Act exist, but this is the most commonly used one by far"). The "qualified purchaser" standards generally require individuals to have "investments" in excess of $5 million and institutions to have "investments" in excess of $25 million.

16 S. Rep. No. 104-293 (1996).

17 The Proposing Release cited to 24 separate actions, however, 22 of the cited actions were settled without findings. In addition, those cases were brought over a period of 17 years in an industry with, as the Proposing Release notes, well over 50,000 participants. This hardly provides support for the view that there is pervasive wrongful behavior across the private fund industry.

the adviser provided side-by-side management to separately managed accounts).[18] This is consistent with the Commission's mandate, and we believe that, instead of using such enforcement actions as a claimed basis for prohibiting activities and practices that have been developed over years of negotiations between sophisticated parties in a competitive market, the Commission should instead focus its resources on enforcing existing rules against actual bad actors in the private fund market.

II. The Commission does not properly account for the negative consequences of the Proposal for investors and presents a flawed analysis of the effects of the Proposal on efficiency, competition and capital formation in the private fund market.

As the Commission notes in the Proposing Release, "[t]he relationship between fund adviser and investor can provide valuable opportunities for diversification of investments and an efficient avenue for the raising of capital, enabling economic growth that would not otherwise occur."[19] However, while the Commission offers several arguments in support of its claims that the Proposal will enhance economic efficiency and competition and facilitate capital formation, it overlooks the likely negative consequences to both investors and advisers that would undermine the very goals the Commission seeks to achieve.

Unintended Consequences for Investors

The Proposal introduces a number of potentially unintended consequences for investors, including, but not limited to:

- All existing open-end and closed end private funds (including funds of one) advised directly or indirectly by registered investment advisers and many existing private funds advised by exempt reporting advisers and foreign private advisers will be affected by one or more of the proposed rules.
- All agreements between investors and funds/advisers (including any side letter with a confidentiality provision) and the organizational documents of many funds, especially closed-end funds, may have to be renegotiated within the proposed one-year transition period and there may be no way to opt out of this retroactive effect.[20]

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[18] *See*, *e.g.,* SEC, 2020 National Examination Program Priorities, https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

[19] Proposing Release, *supra* note 3, at 16943.

[20] Commission rules under the Advisers Act, like other agency rules, are generally subject to a presumption against retroactivity such that (i) "a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms," and (ii) "administrative rules will not be construed to have retroactive effect unless their language requires that result." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988). The Commission has not offered any argument as to why this presumption should be overcome in this case, especially in light of the significant costs that would be imposed as a result of retroactive application. For example, the Proposing Release shows that there were 44,378 private funds attributable to registered investment advisers and 23,940 private funds attributable to exempt reporting advisers based on Form ADV filings between October 1, 2020 and September 30, 2021. Proposing Release, *supra* note 3, at 16935. On these estimates, and assuming conservatively that an average of 50 investors in each fund

- Information routinely sought by investors for their own internal or regulatory reasons (e.g., some custom DDQs/quarterly questionnaires and certain bespoke monthly or quarterly statements) could be considered "preferential" transparency and therefore subject to the Preferential Treatment Rule.
- The fairness opinions requirement may limit the viability of some transactions due to cost or timing delays.
- Requiring advisers to bear expenses currently passed through to funds may result in increased fees overall, resulting in a similar or greater economic burden for investors with less transparency into the sources of underlying costs.
- Mandatory pro rata allocation of some expenses may lead to the unfair allocation of those expenses (for example, if one investor's regulatory or tax needs are driving the expense).
- Some adviser clawbacks will no longer be accepted by advisers.
- Mandated one-size-fit-all quarterly statement disclosure could lead to investor confusion due to the due to the fact that disclosure may not reflect any investor's actual investment experience.
- Some strategies that require a significant level of trading or regulated investments may no longer be offered if the redistribution of the cost of compliance and the changes in the liability standard materially alter the relative economics of the activity.
- Some non-U.S. investment advisers may no longer accept U.S. investors or may not register to allow them to advise separately managed accounts for U.S. investors.
- Fewer new advisers, transitions to family offices and adviser consolidations are possible results which may reduce investor choice.
- Larger investors may redeem from commingled private funds in favor of a separately managed account, leaving smaller investors with smaller funds, higher per unit costs and fewer fund options in some strategies.
- Funds of one may become uneconomic due to the increased costs that would not apply if the fund of one was a separately managed account and may not be permitted if they have different terms than the commingled funds pursuing substantially similar strategies.

Efficiency

The Commission argues that the Proposal could increase the "usefulness" of information investors receive from private fund advisers such that it may "improve the quality of the matches that

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have a side letter with an affected term (including confidentiality provisions which will have to be negotiated away to allow for required disclosures), that could mean as many as 3,484,218 agreements (50 side letters times 68,318 funds plus 68,318 organizational documents to be renegotiated to a greater or lesser degree). Since these are negotiated agreements, there will be significant legal counsel costs for investors, as well as for advisers and funds. At an extremely conservative estimate of $10,000 per investor and per adviser for each agreement, this comes to a staggering $69.7 billion ($20,000 times 3,484,218 agreements) for amending existing agreements – half of which will be borne directly by investors on this estimate – not counting any other types of contractual arrangements that will be affected because of the proposed requirements. This figure increases if subscription agreements and other fund-related agreements need to be amended as well.

investors make with private funds and investment advisers in terms of fit with investor preferences over private fund terms, investment strategies, and investment outcomes."[21] This assumes, however, that investors would prefer the Commission to prescribe the information that private fund advisers must provide them rather than negotiate information requirements for themselves or ask tailored, purposeful questions. A one-size-fits-all approach ignores the reality that each investor undoubtedly has different preferences and priorities in structuring its investments. The Commission in fact concedes this in the Proposing Release, noting that "[t]here may be losses of efficiency from the proposed rules…to the extent that investors currently benefit from those activities or incur costs from those changes."[22] Specifically, such investors "who currently receive preferential terms that would be prohibited under the proposal *may have only invested with their current adviser because they were able to secure preferential terms*."[23] The Proposal disempowers investors by taking away their ability to set their own priorities in the negotiation of private fund terms. Instead of giving investors the flexibility to tailor investments and transparency arrangements to meet their needs, the Proposal substitutes the Commission's own commercial judgment as to what a private fund investor should prioritize when selecting private fund investments.

This loss of flexibility to meet investor needs and demands will negatively affect efficiency in the private fund marketplace. Years ago, when the private fund universe was smaller, the basic fee structure used to be 2 and 20 – every investor paid the same uniform price. Textbook economic theory says this is likely to be inefficient because the adviser will be producing the good/service at too high a price for some investors and therefore under-provide the good/service even though the adviser could provide more of it to meet the demand. Over recent years more efficient solutions have started differentiating in "prices" (reading "prices" broadly to include all material/relevant terms that have a bearing on the investor/fund/adviser relationship).[24] This is effectively moving towards what a top economist refers to as second-degree price discrimination (or even close to first-degree price discrimination in some bespoke situations).[25] The market has moved towards a better equilibrium whereby the advisers can provide more of their services precisely because they are differentiating the terms. Fee structure innovation happens naturally as investors and advisers seek efficient ways to align interests across a variety of factors, including the types of transparency

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21 *Id*. at 16945.

22 *Id*. at 16956.

23 *Id*.

24 *See* AIMA, In Harmony – how hedge funds and investors continue to strike the right note in aligning their interests (July 10, 2019) ("In Harmony Report"). The trend away from one-size-fits-all fee structures has been going on for years. A 2014 Northern Trust paper noted:

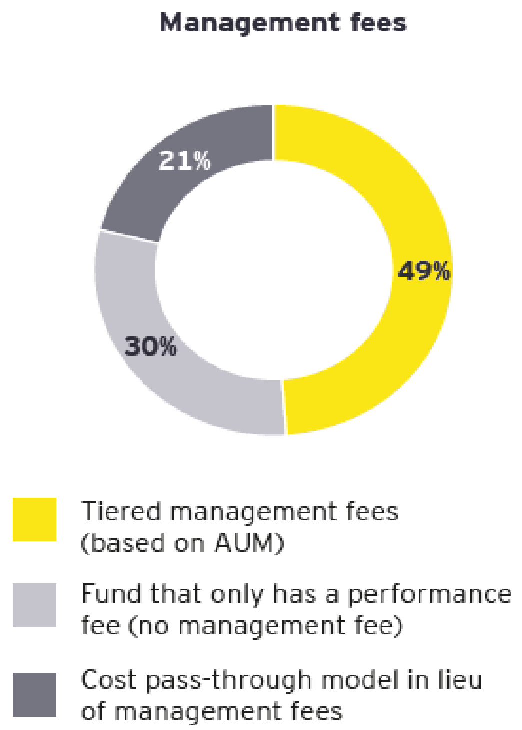
> "Larger investors, such as pension or sovereign wealth funds, in particular, are bringing their weight to bear in requesting changes. Preqin data suggests that the true average today is more along the lines of 1.5 and 18.7.
>
> To address this, some managers are using tiered fee structures to reward larger investments – the more capital an investor commits, the lower the incentive fee it will pay. Others are using share classes creatively through arrangements such as a "founder's" share class with preferential terms for early seed investors."

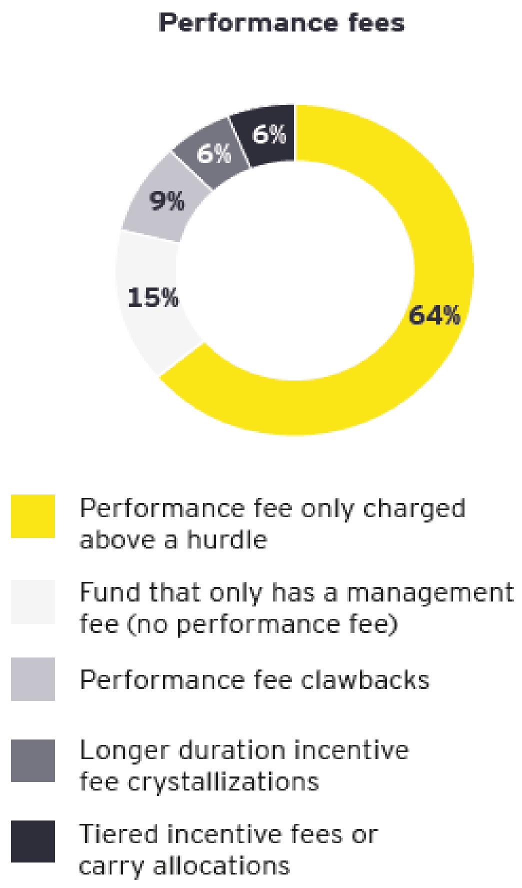
Northern Trust, Seeing Fees in a New Light: How the Hedge Fund Industry is Responding to Fee Pressures (2014), at page 2 ("NT Report").

25 *See* H. R Varian, Differential Pricing and Efficiency, *First Monday*, Volume 1, Number 2 (August 5, 1996).

and liquidity terms which the Commission has proposed to prohibit.[26] As a result, it not surprising that, with the growth of the private markets, we have seen the growth of investor term differentiation. It is pure economics at work.

However, the Commission's Proposal seeks to standardize the types of terms for which investors have a stated preference, and which have allowed the market efficiency to develop from an economic point of view. A recent EY report concludes that "[m]anagers have shown flexibility in their fees and fee structures, improving the value equation for investors" and noting that "investors surveyed preferred flexibility in management fees."[27] In response to the question "which of the following fee structures are most appealing in each category",[28] a significant percentage (see below) responded that they preferred a cost pass-through model in lieu of management fees – an option that the Commission has proposed to ban.





Source: EY Report

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[26] *See* NT Report, *supra* note 24, at page 3.

[27] EY, Can the difference of one year move you years ahead? 2021 Global Alternative Fund Survey, at page 14 ("EY Report").

[28] *Id.*

The Proposal, if adopted as proposed, would move the market away from the equilibrium and back towards a more uniform offering which means that, by definition, fewer investors will be served under such an arrangement.

Competition

The Commission asserts that "[e]nhanced competition from additional transparency" may lead to lower fees and "may direct investor assets to different funds, fund advisers, or other investments,"[29] which, presumably, would result in greater investor choice of private fund investments. However, as drafted, the Proposal is likely to result in greater consolidation within the industry at the expense of smaller, and often more diverse, advisers.

With respect to fees, it is not at all clear that the Proposal would lead to lower fees for investors, and in fact, it is likely to have precisely the opposite effect. By prohibiting the pass through of certain specified categories of expenses, and by increasing the costs and risks of operating private funds more generally, the Proposal creates significant upward pressure on management and other fees (which by their nature provide for less transparency and are likely to incorporate a buffer) as well as incentives to begin passing through expenses that typically are not currently charged to private funds but that are not prohibited by the Proposal. The Proposing Release admits this possibility but notes that it is generally difficult for the Commission to quantify the specific economic effects of the various new requirements and argues, without evidence or analysis, that potential fee increases are likely to be "limited".[30] Furthermore, the Commission acknowledges that certain aspects of the Proposal might reduce revenues to advisers such that certain advisers "may become less competitive as employers" as a result of having to reduce compensation.[31] It is hard to see how making it more difficult for private fund advisers to attract and retain talented portfolio managers would benefit the very investors that rely on such portfolio managers to maximize the returns on their investments.

The Commission fails to articulate why it, rather than sophisticated investors themselves, should be responsible for making these decisions. The Commission appears to see the Proposal as offering investors two options, either the adviser updates their fund terms to fit them within the Commission's prescribed standards or the investor moves its assets into a different fund. But there is a third option which the proposed rule would render unlawful: the adviser and the investor work out terms that are optimal for both parties so that the investor may achieve the benefits associated with the particular investment strategy offered by the adviser. The Commission, quite candidly, admits that investors compelled to withdraw from a fund because of a loss of preferential treatment would redeploy their capital elsewhere. But to where would such capital be redeployed? To another private fund, in which the investor would similarly be prevented from negotiating preferential terms? The Commission itself supplies an instructive answer, noting that investors

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29 Proposing Release, *supra* note 3, at 16956.

30 *Id.* at 16951 ("Investors would therefore benefit from the elimination of fund expenses, which would otherwise reduce investor returns, associated with reimbursing or indemnifying the adviser for losses associated with its malfeasance. These benefits may be diminished to the extent that advisers are able to obtain alternative permissible sources of compensation for these expenses from investors (for example, from increased management fees), although this ability would likely be limited.").

31 *Id*. at 16946.

"may redeploy their capital away from private funds more broadly and into investments with less effective capital formation."[32]

Additionally, the Proposal is likely to create meaningful barriers to entry by new advisers as well as harm smaller advisory firms, a higher proportion of which are women- and minority-owned than larger firms.[33] The costs associated with complying with the Proposal, both direct and indirect, are likely to be quite substantial, and we would expect them to impose a greater burden on new advisers and smaller advisers, who may have less capacity to absorb them. The Commission expects that advisers will incur the bulk of the costs associated with compliance initially, rather than on an ongoing basis, which is likely to pose a greater burden on smaller advisers that may not have as much capacity to take on these sudden, substantial costs. However, as a general matter we disagree with the Commission's assessment that these costs will be transitory and, in most cases, largely absorbed by the adviser. Rather, we believe that most advisers with strong track records – and thus a greater ability to retain investors – will ultimately pass these costs on to their funds (such as by adding or increasing their management fees), resulting in higher ongoing costs to investors.

Furthermore, the Commission recognizes that certain advisers "may also face costs in the form of declining revenue, declining in compensation to fund personnel and a potential resulting loss of employees, or losses of investor capital."[34] It is, again, not hard to imagine which advisers are more likely to experience these impacts. The Proposal will increase costs, dramatically reduce competition and smaller firms without the economies of scale will not survive. New and emerging advisers, disproportionately women- and minority-owned, for whom the breakeven point will be raised significantly due to the Proposal, may respond by seeking a merger with a larger adviser, leading to greater industry consolidation and less diverse ownership, or may opt for an alternative business model such as becoming a family office or only offering separately managed accounts. The Proposal may, by extension, entrench established asset managers at the cost of smaller managers seeking to innovate and/or disrupt the market and/or invest in non-traditional investment strategies.

The Commission notes that the Proposal does not preclude advisers from responding to these increased costs by raising the prices of their services, provided that such services are not prohibited and are appropriately disclosed. Newly-formed and smaller advisers may be more likely to be forced into a position to raise prices because they will have greater difficulty absorbing the added costs of the Proposal. New funds are likely to have higher fees in order to account for certain costs that are unquantifiable *ex ante* (such as costs for regulatory examinations and compliance fees). While their investors will be made aware of the higher fees, such investors may respond in turn by allocating their capital away from new advisers and funds. Again, shifting the

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32 *Id*. at 16956.

33 *See* Knight Diversity of Asset Managers Research Series: Industry (2021), at 11 ("[T]he story seems to be one in which diverse-owned firms manage fewer, smaller funds than their non-diverse peers. In fact, this is a trend we generally see across each asset class.").

34 Proposing Release, *supra* note 3, at 16944.

competitive advantage to legacy firms would result in more consolidation and less diversity in the private funds industry.

Finally, it is worth noting that while the Commission seeks to expand investment opportunities for investors such as pension funds, the Proposal, by imposing substantial new requirements on registered investment advisers, may actually have the unintended consequence of limiting investment choices.[35] For example, a non-U.S. private fund adviser who has qualified as an exempt reporting adviser may seek to mitigate the higher costs of managing private funds with U.S. investors by offering separately managed accounts, instead of private funds for U.S. investors. However, the Proposal could also result in certain of such advisers reweighing the costs and benefits of registration and opting against registration, thus reducing investor access to non-U.S. investment advisers.

<u>Capital Formation</u>

Without providing any supporting data, the Commission expresses the view that the Proposal would facilitate capital formation "by causing advisers to more efficiently manage private fund clients, by prohibiting activities that may currently deter investors from private fund investing because they represent possible conflicting arrangements, and by enabling investors to choose more efficiently among funds and fund advisers."[36] This would, the Commission asserts, provide portfolio companies with greater access to funding for private fund investments.

The Commission offers no support for the claim that investors are being deterred from private fund investing and, in fact, justifies the Proposal in part on the basis that private funds "continue growing in size, complexity, and number."[37] Specifically, the Commission reports that the assets under management of all private funds reported by registered investment advisers and exempt reporting advisers have grown by 55% and 150%, respectively, over the past five years. The number of private funds managed by registered investment advisers and exempt reporting advisers grew 31% and 40%, respectively, during this period.[38] If insufficient disclosures and concern about possible conflicted arrangements were deterring investors from private fund investing, we would expect to see such figures trending in the opposite direction.

Furthermore, as discussed above, the costs of the Proposal are likely to fall more heavily on new and smaller advisers, who, in turn, may balance the cost of establishing new private funds against the significant costs of this proposal and opt for non-private fund investment arrangements (such as operating a family office or offering only separately managed accounts) that, while not subject to the Proposal, are not likely to facilitate the same level of fundraising. For example, in opting not to extend the audit requirement to all advisers, the Commission admits that the cost of obtaining

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35 For example, a December 2018 report by the European Commission on the Alternative Investment Fund Managers Directive ("AIFMD") found a majority of respondents agreeing to the statement that restrictions on the types of non-EU/EEA alternative investment funds that could be marketed into the EU *increased* as a result of the heightened requirements under AIFMD. European Commission, <u>Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD), Directive 2011/61/EU</u> (10 December 2018) ("AIFMD Report").

36 Proposing Release, *supra* note 3, at 16956.

37 *Id.* at 16887.

38 *Id*. at 16936.

such an audit for a smaller fund advised by an unregistered adviser "could inhibit entry of new funds, potentially constraining the growth of the private fund market."[39] It is not clear, however, how this is also not the case with respect to the entry of new funds advised by smaller *registered* advisers or new advisers that may find themselves subject to registration. Even for more established fund managers, the overall impact of the Proposal might render certain strategies economically nonviable such that they can no longer be offered. Accordingly, it is more likely that the Proposal will result in fewer private fund offerings, which means fewer options for investors and less capital for new and emerging companies.

III. The Proposal is not supported by appropriate statutory authority.

A. Section 211(h)

The Commission, in the first paragraph of the Proposing Release, cites to Section 211(h) of the Advisers Act ("Section 211(h)"), which provides that the Commission shall:

> "[E]xamine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes … that the Commission deems contrary to the public interest and the protection of investors."[40]

Each of the Quarterly Statement Rule, the Prohibited Activities Rule, the Adviser-Led Secondaries Rule and the Preferential Treatment Rule has been proposed under the purported authority set forth in Section 211(h).[41] It would be an improperly broad reading of Section 211(h) to extend the Commission's authority to prescribe such requirements for private fund advisers with respect to their relationship with private funds and private fund investors.

To understand the scope of the Commission's authority under this provision, it is instructive to examine the provision's legislative history. Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") sought to address the standards of care for brokers, dealers and investment advisers by mandating a Commission study (the "Section 913 Study") to evaluate the effectiveness of and gaps in then-existing legal or regulatory standards, authorizing (but not requiring) the Commission to commence a rulemaking to address such standards and amending the Advisers Act and the Exchange Act to provide the Commission with the statutory authority to address standards of conduct and certain other matters.[42] The Dodd-Frank Act added Section 211(h) as well as Section 211(g) to the Advisers Act as part of that new statutory authority.

Both the statutory text of Section 913 and the Commission's Section 913 Study are clear that both Congress and the Commission had the protection of *retail* investors in mind in crafting these requirements. Subsection (b) of Section 913, requiring the Section 913 Study, required the Commission to assess the effectiveness of existing standards of care for brokers, dealers,

39 *Id*. at 16956.
40 15 U.S.C. 80b-11(h).
41 Proposing Release, *supra* note 3, at 16970.
42 Dodd-Frank Act, section 913, Public Law 111–203, 124 Stat. 1376 (2010).

investment advisers and associated persons "for providing *personalized investment advice* and recommendations about securities to *retail customers* ..." and to examine whether there were gaps in legal or regulatory standards "in the protection of *retail customers* ...."[43] Subsection (f) of Section 913 authorized the Commission to commence a rulemaking "as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care ... for providing *personalized investment advice* about securities *to such retail customers*."[44] Notably, Section 211(h) was added to the Advisers Act together with Section 211(g). Section 211(g) not only refers to "personalized investment advice to retail customers (and such other customers as the Commission may by rule provide)" but it in fact *prohibits* the Commission from ascribing a meaning to the term "customer" that includes "an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser."[45]

The Section 913 Study makes clear that the Commission's Staff viewed the Commission's mandate as the protection of retail investors. The Staff stated that its recommendations therein were "intended to make consistent the standards of conduct applying when *retail customers* receive personalized investment advice about securities from broker-dealers or investment advisers."[46] The recommendations further included "suggestions for considering harmonization of the broker-dealer and investment adviser regulatory regimes, with a view toward enhancing their effectiveness *in the retail marketplace*."[47] Nowhere in the report are private fund investors mentioned.

As the Commission notes in the Proposing Release, the Dodd-Frank Act amended the Advisers Act to require certain registration, reporting and recordkeeping requirements for private fund advisers. However, it clearly sought to distinguish the obligations of investment advisers managing private funds from those managing investment vehicles with retail investors (such as mutual funds) or otherwise delivering personalized investment advice to retail investors. It would be an unreasonably broad reading of the authority granted to the Commission under Section 211(h) of the Advisers Act to conclude that such provision extends to the types of requirements and prohibitions contained in the Proposal.

B. Section 206(4)

Section 206(4) of the Advisers Act, also cited for authority in the Proposing Release, states:

> "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly— ...
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably

43 *Id*. at section 913(h).
44 *Id*. at section 913(f).
45 15 U.S.C. 80b-11(g).
46 SEC, Study on Investment Advisers and Broker-Dealers (January 2011), at pg. ii.
47 *Id*.

> designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[48]

Since 2007, the Commission has asserted the authority to prevent advisers to private funds from engaging in fraudulent, deceptive or manipulative practices under Rule 206(4)-8, which prohibits all investment advisers to pooled investment vehicles from making false or misleading statements to investors or prospective investors in pooled investment vehicles they advise, or otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to such investors or prospective investors. In fact, in the Proposing Release, the Commission asserts that private fund advisers "can assume that conduct that would raise issues under any of the specific provisions of the proposed rules *would also be prohibited under rule 206(4)-8*."[49]

The Commission notes in the Proposing Release relating to prohibited activities:

> "The proposed rule would prohibit these activities regardless of whether the private fund's governing documents permit such activities or the adviser otherwise discloses the practices and regardless of whether the private fund investors … have consented to the activities …."[50]

The Commission has not previously suggested that the activities proscribed by the proposed rules, however, were in any way fraudulent, deceptive or manipulative where properly disclosed and consented to by investors. The Commission Staff's periodic reports regarding examination findings, for example, have never asserted that agreements that included exculpation and indemnification for all losses other than those caused by gross negligence or willful misfeasance or that provided preferential terms to investors, both commonplace, were inherently fraudulent or deceptive or otherwise prohibited under the Advisers Act. The Commission's concerns have always been around *disclosure*. We question how fully disclosed terms, agreed to by highly sophisticated parties in a very competitive market, could truly be fraudulent, deceptive or manipulative.

The Commission intends for the Proposal to provide for the "particularized requirements" that Rule 206(4)-8 lacks but fails to articulate *why* the practices at issue here are by their nature fraudulent, deceptive or manipulative such that particularized requirements are necessary. Indeed, the Commission *could* not (nor could anyone else) provide any such explanation, for any practice agreed upon by consenting parties in a competitive market with full and fair disclosure, is inherently not fraudulent, not deceptive and not manipulative.

Under these circumstances, it strains credibility to the breaking point to assert, as the Commission does, that the additional costs to private funds from the proposals would be minimal due to the substantial overlap between the Proposal and prohibited activities under Rule 206(4)-8. Several of these practices are currently common in the private fund market (such as providing preferential treatment in side letters and reducing adviser clawbacks for taxes) and have not otherwise, prior

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48 15 U.S.C. 80b-6(4)
49 Proposing Release, *supra* note 3, at 16973.
50 *Id.* at 16920.

to the Proposal, been deemed prohibited (so long as there has been full and fair disclosure) by the Commission.

IV. Given the scope and substantial impact of the Proposal, the Commission has not conducted an appropriate cost-benefit analysis that considered less burdensome alternatives.

The Commission's economic analysis, as laid out in the Proposing Release, insufficiently establishes a baseline of current practices and inadequately assesses the costs and benefits of the Proposal to both advisers and investors.[51] The Commission's economic analysis is sparse and anecdotal at best, failing to appropriately consider the substantial negative effects of the proposed rules or to provide proper consideration of less costly alternatives. Moreover, by providing industry participants an exceedingly short comment period in which to gather and share relevant data with the Commission, it is impossible for the Commission to conduct a thoughtful economic analysis appropriately tailored to scope of the Proposal. Imposing such significant costs (and, in many cases, assuming away or failing even to acknowledge their existence) without any plausible estimate of the benefits does not comport with the Commission's obligations under the Administrative Procedure Act.[52]

The Commission itself concedes in the Proposing Release that it cannot estimate the benefits to investors resulting from these far-reaching proposals. With respect to the Prohibited Activities and Preferential Treatment Rules, two of the most burdensome requirements under the Proposal, the Commission notes that "there is a lack of data on the extent to which advisers engage in certain of the activities that would be prohibited under the proposed rules, as well as their significance to the businesses of such advisers."[53] This lack of information forces the Commission to admit that it cannot quantify the very real costs that will be borne by investors as a result.[54]

Where the Commission *has* sought to undertake cost estimates to advisers, in connection with the Paperwork Reduction Act, the considerable effect on the industry is made clear. For example, the Commission estimates that just two of the rules—the Quarterly Statements Rule and the Mandatory Audit Rule—would cost advisers in excess of **$3 billion *on an annual basis***.[55] In several other cases, the Commission makes a passing reference to costs (including costs that would obviate any corresponding benefits) but does not explain why those costs would be justified.[56]

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51 *See* SEC, Current Guidance on Economic Analysis in SEC Rulemakings, Memorandum (March 6, 2012) (identifying the elements as follows: "(1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis.").

52 *See* Motor Vehicle Mfrs. Ass'n of U.S., Inc., 463 U.S. 29, 43, 103 S.Ct. 2856, 77 L.Ed.2d 443 (1983) (an agency must "examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choices made"). *See also* Bus. Roundtable, 647 F.3d 1144 (D.C. Cir. 2011).

53 *See* Proposing Release, *supra* note 3, at 16948.

54 *Id.*

55 *Id.* at 16962-16964.

56 The Commission concedes, for example, that with respect to the prohibition on charging funds expenses in connection

Furthermore, the Commission repeatedly fails to consider less burdensome alternatives that would still effectively address its goals. Although there are several examples of this throughout the Proposal, which we address throughout the course of this response, we wanted to highlight a few in particular:

- Prohibition on limiting liability: Despite the fact that it is common industry practice for advisers and other market participants to operate under a gross negligence and willful misfeasance standard of care, the Commission now seeks to mandate a higher standard without considering less burdensome alternatives such as requiring prescriptive disclosure for those advisers that have limited their state and foreign law duties to the effect that their Federal fiduciary duties cannot be waived.

- Quarterly statement requirement. The Commission's Quarterly Statement Rule would impose onerous reporting requirements on private fund advisers, despite the Commission's acknowledgement that many private fund investors already receive fulsome disclosure of fees, expenses and performance. The Commission admits that there is a lack of quantitative data on the extent to which advisers currently provide information that would be required under the proposed rule, yet it failed to undertake such an analysis before proposing these new requirements in order to assess whether existing reports were sufficient. Furthermore, the Commission neglected to consider less burdensome timing and frequency requirements, such as those that apply to required reports to mutual fund shareholders, or whether reports that many advisers already provide to investors, such as financial statements prepared in accordance with GAAP, could suffice.

- Mandatory audits. The Commission has estimated that the Mandatory Audit Rule would cost the industry in excess of **$2.7 billion *per year***.[57] However, despite the rule's substantial overlap with the Custody Rule under the Advisers Act, the Commission did not consider less burdensome alternatives that would avoid duplicative and costly audit requirements.

V. The Commission's proposed prohibition on limiting liability for certain types of conduct would fundamentally change long-standing industry practice and lead to unintended consequences in the behavior of market participants.

We strongly believe that the Commission should revise the Proposal to eliminate the prohibition on exculpation and indemnification for breach of duty, willful misfeasance, bad faith, negligence, and recklessness. This would better align with prevailing market practice, the needs and expectations of investors and the standards applicable to mutual funds.

Throughout the financial services industry, gross negligence and willful misfeasance is the most common liability standard used in indemnification and exculpation clauses. This is the case not

with a regulatory examination, "advisers could introduce substitute charges (for example, increased management fees)." Proposing Release, *supra* note 3, at 16948. However, when increasing management fees, advisers likely will build in buffers to account for the uncertainty in what actual expenses might be. As a result, investors will find themselves paying higher costs, while at the same time losing transparency about what costs are being subsumed in the management fee.

57 *Id.* at 16964.

only for fund services providers (such as investment advisers, custodians, administrators, prime brokers, placement agents, auditors and fund directors) but also in other contexts. We are not aware of any other industry that limits indemnification in the manner set forth in the proposed rule.

The Proposal creates a higher standard of care for advisers with respect to private fund investors than the standard Congress mandated for advisers with respect to retail investors. Section 17(i) of the Investment Company Act prohibits advisory contracts from containing any provision which protects or purports to protect the adviser against liability for "willful misfeasance, bad faith, or *gross* negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract or agreement."[58] Under the Proposal, a private fund adviser would be prohibited from limiting liability for "a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness." Thus, private funds will be unable to protect their advisers from claims for which advisers to registered funds (such as retail mutual funds) can be protected, notwithstanding the fact that the risks (and resulting benefits) of mutual fund investment strategies and operations are materially lower than those of private funds.

Private fund advisers and investors have long been aware of these standards and have structured their relationships accordingly. The Proposal would fundamentally alter the risk profile for private fund advisers, who have been able to develop and implement strategies (and open such strategies to investors) in part on the basis that they would not be subject to *ex post* second-guessing of legitimate investment decisions that ultimately resulted in losses or held liable for certain unintentional mistakes, such as, for example, trade and other errors. If adopted as proposed, advisers would almost certainly be incentivized to limit the strategies offered to investors, limit the types of investors admitted to their funds and/or limit the number of investors in such funds. New advisers may be discouraged from forming funds if they are unable to receive the appropriate liability protections. Investors may find it more difficult to access funds and investment strategies to the extent that advisers respond to the Proposal by reconsidering the types of strategies they manage and investors they are willing to accept, given the heightened risks.

Furthermore, it is likely that errors and omissions insurance premiums will increase as a result of the proposed rule, and the fact that advisers may no longer rely on existing indemnification arrangements would also likely put pressure on other fees and expenses. As with many other aspects of this Proposal, this will fall heavily on new and smaller advisers (including minority- and women-owned businesses), and present impediments to entry and/or growth. This would also harm investors, particularly existing investors, who understand that advisers are able to take greater risks (and generate higher returns) in return for certain contractual indemnities and limitations on liability, and who may ultimately have to bear a portion of the additional costs assumed by advisers in connection with these new prohibitions.

[58] 15 U.S.C. 80a–17(i) (emphasis added).

VI. The Commission should reaffirm its long-standing view that non-U.S. registered investment advisers (with respect to offshore funds) and exempt reporting advisers should not be subject to the substantive requirements of the Advisers Act.

The Commission has historically distinguished between SEC-registered and exempt advisers with respect to substantive requirements it imposes under the Advisers Act. As currently proposed, the Prohibited Activities Rule and the Preferential Treatment Rule would apply to advisers not registered with the Commission, including non-U.S. advisers relying on the foreign private adviser or private fund adviser exemptions. We would respectfully urge the Commission to reconsider the application of these rules, as we strongly view such application as inconsistent with the Commission's historical treatment of these advisers.

Subjecting non-registered advisers to additional substantive requirements under the Advisers Act undermines the very purposes and goals of these exemptions, particularly in the case of non-U.S. advisers that rely on the private fund adviser exemption in order to access capital from U.S. investors. Advisers that rely on the private fund adviser exemption or foreign private adviser exemption often do so in order to access U.S. investor capital without having to subject themselves to the full Advisers Act regulatory regime. The Commission itself has recognized that U.S. investors may be precluded from opportunities to invest in offshore funds if offshore advisers were so regulated, and thus understand that they cannot expect the full protections of the U.S. securities law with respect to their investment in the offshore fund.[59] Both the Custody Rule and the Marketing Rule, for example, only apply to registered advisers. Extending these rules to those offshore advisers will likely chill their U.S. activities as it is possible that non-U.S. advisers may determine that the costs of being an exempt reporting adviser outweigh the benefits of participating in the U.S. market. This would have the effect of reducing U.S. investor access to the widest possible range of advisers and investment strategies.

Moreover, non-U.S. advisers relying on one of these exemptions may be already subject to substantive regulation in other jurisdictions, creating the potential for conflict with these new requirements. In the AIFMD Report, for example, many respondents in the report's survey frequently mentioned that AIFMD resulted in restricted access to the EU market for non-EU funds, including due to perceived administrative burdens and additional costs to non-EU advisers with no similar requirements in their home jurisdictions.[60] Finally, the number of U.S. investors and amount of U.S. capital in funds managed by exempt foreign private advisers is minimal (as a result of the requirements of the exemption) such that the consequences of the rule would be especially disproportionate in light of the actual risk to U.S. investors.

The Commission has also 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 non-U.S. funds) of a registered offshore adviser. The Commission should continue to take its historic approach with respect to all of the proposed rules, as it has, to date, successfully facilitated the expansion of investment opportunities for U.S. investors and access to U.S. capital for registered offshore advisers. Registered offshore advisers newly subject to substantive prohibitions and requirements

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[59] Proposing Release, *supra* note 3, at 16921.

[60] AIFMD Report, *supra* note 34, at 103.

of the Advisers Act with respect to their offshore funds may weigh these additional costs and determine that it is no longer desirable to offer these products to U.S. investors or might compel existing U.S. investors to redeem their interests, to the extent permitted under the fund documents. This could result in fewer new fund products being offered in the United States.

Furthermore, for the avoidance of doubt, the Commission should clarify that the proposed rules will also not apply with respect to the offshore private fund clients of an *unregistered* offshore adviser. A different application would have the illogical result of imposing more onerous requirements on unregistered offshore advisers than on registered offshore advisers, despite the fact that the historical justifications for excluding offshore clients of registered advisers apply equally with respect to offshore clients of unregistered advisers.

VII. The Commission must clarify the scope of the Proposal as it relates to "indirectly" advising a private fund.

The Quarterly Statement Rule and the Mandatory Audit Rule apply with respect to any private fund that a registered investment adviser "directly or indirectly" advises, however, the Commission does not provide any guidance on what it means to "indirectly" advise a private fund in this context. We presume that this is meant to capture sub-advisory relationships between a fund and a registered adviser, yet the ultimate compliance burdens and associated costs of these requirements will vary considerably depending on the scope of "indirect" advice for purposes of these rules.

A U.S. registered investment adviser could sub-advise an offshore private fund (i) advised by one of its non-U.S. relying advisers, (ii) advised by another registered investment adviser's non-U.S. relying adviser, or (iii) advised by a non-U.S. adviser exempt from investment adviser registration under either the private fund adviser exemption or the foreign private adviser exemption. In each case, the primary adviser would either explicitly *not* be subject to the Quarterly Statement Rule and the Mandatory Audit Rule (because the primary adviser is not registered) or, based on the Commission's historic position regarding the application of the substantive provisions of the Advisers Act, not be subject to the rules with respect to their offshore funds.[61] However, under the Proposal, the U.S.-registered investment adviser would seemingly be responsible for complying with the Quarterly Statement and Mandatory Audit Rules in relation to the sub-advised fund. Such sub-advisers may respond by limiting their sub-advisory relationships, or advisers may be less willing to engage them as sub-advisers, thereby depriving non-U.S. advisers and funds of their knowledge and expertise.

Moreover, a sub-adviser would likely not even be in a position to compel a sub-advised private fund to undergo an audit (or impose specific criteria with respect to such audit). A sub-adviser furthermore is typically not in contact with investors in a sub-advised private fund and in most cases would not have the information necessary to prepare and deliver the statements required by the Quarterly Statement Rule.

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[61] *See* Proposing Release, *supra* note 3, at 16921.

We would specifically urge the Commission, therefore, to clarify that a registered U.S. sub-adviser would not need to comply with the Quarterly Statement and Mandatory Audit Rules with respect to a private fund whose primary adviser is not subject to the rules.

VIII. Responses to the Commission's general questions regarding the Proposal

1. Are there certain activities that this package of proposed reforms would address in the private fund context that we should also address in other contexts (e.g., separately managed accounts)? Why or why not?

We do not believe that the Proposal (or any proposed rule therein) should be extended to any other types of advisory relationships, as this will ultimately result in more industry consolidation and greater limitations on investment options available to investors, given the substantial costs that will be associated with compliance.

2. Are there certain activities in the private fund context that this package of proposed reforms is not addressing but that we should address?

No. The breadth of the Proposal is already far more extensive than is appropriate given the Commission's traditional approach to private funds and private fund advisers and its failure to cite widespread and pervasive issues in the private fund market that justify burdensome new obligations on private fund advisers.

IX. Responses to the Commission's questions regarding the Quarterly Statement Rule

Generally

3. Should we, as proposed, require advisers to private funds to prepare a quarterly statement providing standardized disclosures regarding the cost of investing in the private fund and the private fund's performance and distribute the quarterly statement to the fund's investors? Should we instead require advisers to provide investors with personalized information that takes into account the investors' individual ownership stake in the fund in addition to, or in lieu of, a statement covering the private fund? If so, what information should be included in the personalized disclosure? For example, should the statement reflect specific fee arrangements, including any offsets or waivers applicable only to the investors receiving the statement? Do advisers currently provide personalized fee, expense, and performance disclosures? If so, what other types of information do advisers or funds typically include? Do they automate such disclosures? How expensive and complex would it be for advisers to create and deliver personalized disclosures? How useful would it be for investors to receive personalized disclosures?

We believe that this proposal is unnecessary and would fail to provide increased transparency, given that most advisory firms already provide various forms of quarterly and other periodic reporting and investors are generally able to negotiate for and receive the disclosure appropriate for their particular needs. Because the information that would be required under the Proposal would relate to an entire fund, and therefore not reflect the experience of any actual investor (who would be invested in a particular class or series of interests), investors who receive this information are still likely to ask for more tailored reporting, which in turn would impose greater costs on advisers (and which would presumably be disclosable preferential treatment under the Preferential Treatment Rule, which may raise confidentiality concerns for investors).

While the Commission justifies the Quarterly Statement Rule on the basis that the required statements would "improve the quality of information provided to fund investors, allowing them to assess and compare their private fund investments better"[62] the Commission recognizes that many private fund advisers already contractually agree to provide such reporting to investors as a matter of market practice, that limited partners may obtain information regarding fees and expenses on the quarterly account statements provided pursuant to Custody Rule, and that registered investment advisers are already required to disclose information regarding fees and compensation on the publicly available Form ADV.[63] Additionally, certain hedge fund investors receive such information under the rules promulgated by the Commodity Futures Trading Commission ("CFTC").[64] The Commission admits that the magnitude of the effect of the Quarterly Statement Rule depends on the extent to which investors do not already have access to the information that would now be included in the quarterly statement and how much investors would even use such information, neither of which the Commission attempted to quantify. Thus, the Commission's basis for instituting this requirement appears to be not that private fund investors are unsatisfied with the existing information available to them, or that such information is in and of itself inadequate, but rather that not all advisers are providing information in accordance with the preferences of the Commission.

The Commission notes that lack of disclosure has been at issue in enforcement actions against private fund advisers, citing three enforcement actions brought in 2014 and 2015.[65] But the very fact that the Commission has singled out a small number of advisers for enforcement suggests that improper disclosure is not the sort of widespread activity that necessitates a new and costly mandate from the Commission and, in fact, that existing rules are being properly enforced. Indeed, the activities at issue in the three enforcement actions (failure to disclose accelerated monitoring fees and disparate fee discounts, failure to disclose charges for legal and compliance expenses and failure to follow an expense allocation policy) would not have been prevented by the quarterly statement requirement.[66]

However, if the Commission adopts the rule, it should require statements to be furnished to investors on *no more than* a *semi-annual basis*, with the semi-annual statement covering the first six months of the fiscal year due within 60 days of the end of the reporting period and the annual

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62 Proposing Release, *supra* note 3, at 16890.
63 *Id*. at 16938.
64 *Id*. at 16939.
65 *Id*. at 16892.
66 We would also note that all three cases were settled cases in which no determination was made by any factfinder that the alleged failures to disclose actually occurred or, that if they did occur, that the failures were material under the circumstances. Furthermore, we would point out that respondents often enter into a settlement notwithstanding their belief that the Commission's case is without merit. Under Rule 408 of the Federal Rules of Evidence, a settlement is not admissible "either to prove or disprove the validity or amount of a disputed claim ...." and we believe it should not be a viable argument for regulatory change.

report due within 120 days of the end of the fiscal year. The Commission did not consider this less burdensome alternative, which would align the requirements with those applicable to reports to mutual fund shareholders under the Investment Company Act.[67] The Commission should not impose more onerous reporting requirements with respect to private fund investors than it does with respect to registered fund investors.

Furthermore, if the Commission ultimately opts to require new investor reporting, we believe it should provide flexibility to advisers through a principles-based approach and not prescribe one-size-fits-all standardized disclosures that would require continual revision as the market changes and that do not even accord with the preferences of many private fund investors. A principles-based approach would allow advisers to prepare the required statement on the basis of how they account for and present the relevant information in the fund's audited financial statements in order to maintain the consistency of reporting.

In light of the above, we also do not believe that the Commission should require the provision of personalized information. Preparing such disclosure would be an extraordinarily costly and time-intensive exercise for advisers (particularly with respect to funds with a large number of investors with varied terms, and/or for advisers that manage multiple private funds, as many do) because of the need to develop/modify tools to compile and calculate the required information on such a granular level of detail and to review each such statement before it goes to an investor, among other things. Currently, where there are different classes, an adviser may use a representative investor as a proxy in order to calculate and report information by class, the difficulties of which would be compounded exponentially if this process had to be undertaken for each investor. Furthermore, to the extent that an adviser already provides personalized information to an investor, such disclosure should continue to reflect negotiations between the adviser and the investor. Investors are best positioned to decide for themselves the fee, expense and performance information that is most useful to them, and this answer is unlikely to be the same for every investor.

4. **Would investors find data regarding the private fund's fees, expenses, and performance useful given that certain investors may have different economic arrangements with the adviser, such as fee breaks or expense caps? Should we require advisers to disclose in the quarterly statement whether investors are subject to different economic arrangements, whether documented in side letters or other written agreements or, to the extent applicable, as a result of different class terms? If so, should we require advisers to list the rates or otherwise show a range?**

As a general matter, many funds offer several types of interests to accommodate the needs of different investors, and each such interest will experience different economic outcomes. Therefore, instead of being forced to receive reporting that reflects Commission-mandated metrics, and which may prove confusing – or worse, misleading – to investors in light of their particularized experience in the fund, investors should be allowed to continue to work with advisers to request and receive information that is relevant to them.

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[67] 17 C.F.R. § 270.30e-1.

With respect to fee caps and expense breaks, to the extent that such caps and breaks are reflected in the overall amounts paid to the investment adviser, we believe that simple disclosure of the existence of such arrangements, without revealing the specific rates or investors to whom they apply, would be appropriate.

Finally, we would note that where multiple share classes are offered, the relevant terms applicable to each class are generally disclosed in materials received by all investors, and therefore any such disclosure in the periodic statement would be duplicative and unnecessary.

5. **Should the quarterly statement rule apply to registered advisers to private funds as proposed or should it apply to all advisers to private funds? Should it apply to exempt reporting advisers? Should the rule include any exceptions for categories of advisers? If so, what conditions should apply to such an exception?**

The Quarterly Statement Rule, if adopted, should only be applied to registered advisers to private funds as proposed. The Commission has, with limited exceptions, traditionally not applied the substantive provisions of the Advisers Act to investment advisers exempted from registration, such as exempt reporting advisers relying on the private fund adviser exemption. Additionally, we believe that the Quarterly Statement Rule should not apply with respect to the non-U.S. clients (including funds) of a registered offshore adviser. This accords with the Commission's historical position that most of the substantive provisions of the Advisers Act do not so apply.[68]

Please see our discussion in Section VI for additional thoughts on these matters.

6. **Should the rule require advisers to prepare and distribute the quarterly statements only to private fund investors, as proposed? Alternatively, should the rule require advisers to provide quarterly statements to investors in other types of pooled investment vehicles, such as a vehicle that relies on an exclusion from the definition of "investment company" in section 3 of the Investment Company Act other than section 3(c)(1) or 3(c)(7) of that Act? For example, should we require advisers to provide quarterly statements to investors in pooled investment vehicles that rely on the exclusion from the definition of "investment company" in section 3(c)(5)(C) of that Act?**

We believe that instead of expanding the categories of investors that would receive periodic statements, the Commission's goals would be better served by taking a more targeted approach. Specifically, if the Commission intends to adopt the Quarterly Statement Rule, we would recommend excluding investors in private funds that are "qualified purchasers" (as defined in Section 2(a)(51) of the Investment Company Act and the rules and regulations thereunder) and/or "knowledgeable employees" (as defined in Rule 3c-5 under the Investment Company Act).[69] These investors have sophistication and knowledge such that providing them the type of periodic statement mandated by the Proposal would offer few, if any, additional benefits and these would be largely outweighed by the costs to the adviser in terms of time and resources.

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[68] Proposing Release, *supra* note 3, at 16921.

[69] *See supra* note 15 and accompanying text.

Furthermore, the Commission should exclude investors in private funds for which the adviser is a registered commodity pool operator or is relying on the exemption under CFTC Regulation 4.7. Such advisers are already required to provide monthly or quarterly account statements to investors, which, the Commission concedes "could have the effect of mitigating some of the benefits of the proposed rule"[70] and the Commission does not offer any indication in the Proposing Release that investors find the information provided in the CFTC-mandated statements inadequate or presented in a manner that is not easily understandable such that new data would be materially beneficial to them.

Finally, expanding these requirements to apply to investors in vehicles relying on exclusions from the definition of "investment company" other than Section 3(c)(1) or 3(c)(7) of the Investment Company Act, such as Section 3(c)(5)(C), would establish a troublesome precedent given that the Commission and market participants have long understood the term "private funds" to encompass only Section 3(c)(1)/3(c)(7) vehicles (and this is, of course, reflected in the definition of "private funds" in the securities laws). Many advisers have structured their pooled investment vehicles such that they could rely on exclusions other than Section 3(c)(1)/3(c)(7) and admit a wider range of investors. Subjecting advisers to such vehicles to the Quarterly Statement Rule (or any other aspect of the Proposal) could have a chilling effect on the formation of such vehicles, not only further limiting choices for investors, but making it more difficult to raise capital for, in the case of Section 3(c)(5)(C) vehicles, real estate and real estate-related projects, harming capital formation.

7. **The proposed rule would require an adviser to distribute the quarterly statement to the private fund's investors within 45 days after each calendar quarter end, unless such a quarterly statement is prepared and distributed by another person. Would this provision eliminate burdens where there are multiple advisers to the same fund, while still providing the fund's investors with the benefits of the quarterly statement? Would the fund's primary adviser typically prepare and distribute the quarterly statement in these circumstances? How would advisers that do not prepare and distribute a quarterly statement in reliance on another adviser demonstrate compliance with this requirement?**

We believe that, where there are multiple advisers to the same fund, the Commission should expressly provide that it is the responsibility of the fund's primary adviser, if such adviser is registered with the Commission, to prepare and distribute the periodic statement. It is important that the Commission recognize that sub-advisers ordinarily would not have access to the information required to prepare or distribute such statements to investors, with whom they typically have no relationship. The Commission should further clarify that the new recordkeeping requirement related to the Quarterly Statement Rule only applies to the registered adviser that is preparing and distributing the statement. The Commission should also clarify the extent of the adviser's responsibilities when a person other than the adviser (such as a fund administrator) prepares and distributes the statement, which is a likely outcome for many AIMA member firms.

8. **The proposed rule would require advisers to prepare and distribute a quarterly statement disclosing certain information regarding a private fund's fees, expenses,**

70 Proposing Release, *supra* note 3, at 16945.

and performance. Are there alternative approaches we should require to improve investor protection and bring greater efficiencies to the market? For example, should we establish maximum fees that advisers may charge at the fund level? Should we prohibit certain compensation arrangements, such as the "2 and 20" model? Should we prohibit advisers from receiving compensation from portfolio investments to the extent they also receive management fees from the fund? Should we require advisers to disclose their anticipated management fee revenue and operating budget to private fund investors or an LPAC or other similar body (despite the limitations of private fund governance mechanisms, as discussed above) on an annual or more frequent basis? Should we impose limitations on management fees (which are typically paid regardless of whether the fund generates a profit), but not impose limitations on performance-based compensation (which is typically tied to the success of the fund)? Should we prohibit management fees from being charged as a percentage of committed capital and instead only permit management fees to be based on invested capital, net asset value, and other similar types of fee bases? Should we prohibit certain expense practices or arrangements, such as expense caps provided to certain, but not all, investors?

The Commission should not set fees or prohibit any types of fee arrangements.

The private fund market has operated successfully for many years with these existing types of fee arrangements in place, many of which are the result of extensive negotiations between advisers and investors. Prohibiting or meaningfully limiting certain fee and expense arrangements could have the unintended consequence of making it more difficult for advisers to attract and retain talent, which would ultimately hurt investors seeking to maximize returns.

To the extent that investors may seek different fee and expense practices and arrangements than what an adviser is offering, they should be empowered to determine for themselves the optimal approach and be given the opportunity to negotiate with the adviser to best align their preferences, rather than have the Commission impose its own commercial preferences. Many advisers have expanded beyond just the "2 and 20" model by virtue of negotiations with investors; some have adopted, for example, "tiered fee" structures in which a declining management fee is paid as the fund's assets under management increases, or a pass-through fee model, or discounted management fees that vary with the fund's strategy.[71]

Flexible fee arrangements have developed out of the specific preferences of certain investors, while others have continued to invest in private funds that deploy a "2 and 20" model, thereby expressing their continued satisfaction with this model. The Commission should continue to encourage innovation in fee structures and to allow sophisticated investors to negotiate in their own interests rather than prohibiting specific commercial arrangements. We also question the Commission's statutory authority to prohibit any fully disclosed fee arrangements in the private funds context. Although Section 205(a) of the Advisers Act does give the Commission some power to regulate fees in limited circumstances, that power is limited by Section 205(b) which prohibits

71 *See* In Harmony Report, *supra* footnote 24.

the application of that power to "an investment advisory contract with a company excepted from the definition of an investment company under section 3(c)(7) of [the Advisers Act]".

Furthermore, the Commission should not require managers to justify fees by reference to an operating budget or empower an LPAC to agree to fees on behalf of other investors. Nor should the Commission prohibit management fees from being charged as a percentage of committed capital and instead only permit management fees to be based on invested capital. Such a prohibition may simply incentivize some advisers to deploy capital as fast as possible and return capital as late as possible, which would lead to an increase in the aggregate management fee revenue as the total return on investment decreases, a misalignment of interests caused by a regulatory change that is wholly avoidable by the Commission.

9. Similarly, should we prohibit certain types of private fund performance information in the quarterly statement? For example, should we prohibit advisers from presenting performance with the impact of fund-level subscription facilities? Should we prohibit advisers from presenting combined performance for multiple funds, such as a main fund and a co-investment fund that pays lower or no fees?

The Commission should not prohibit the use of certain types of private fund performance information, provided that such information is presented in a manner that is consistent with the adviser's fiduciary duties and the antifraud provisions of the Advisers Act and other applicable securities laws. Overly prescriptive requirements and prohibitions may result in the presentation of performance data that may be confusing or even misleading for investors in certain cases. Prohibiting the presentation of performance with the impact of fund-level subscription facilities, for example, would result in a mismatch between the information presented and the actual experience of fund investors.

If the Commission ultimately includes performance information in the required statement, we believe that it has already offered a useful principles-based framework for the presentation of such information in the Marketing Rule and should adopt a similar approach to the presentation of such information in the statement.[72] We would note that the Commission itself has indicated that reporting is often used by investors to determine whether to remain invested in a fund. Accordingly, there would seem to be no reason why the framework offered by the Marketing Rule would not be the appropriate model in this context.

10. Do private fund advisers or their related persons receive other economic benefits that the rule should require advisers to disclose in the quarterly statement? For example, should the quarterly statement also require disclosure and quantification of the kinds of economic benefits commonly received by advisers or their related persons from broker-dealers or other service providers to private funds, such as hedge funds? Why or why not?

[72] *See* Marketing Rule, *supra* note 5, at 13025.

In the event that any periodic statement is required, it should only include, as proposed, amounts paid by the fund itself. We are not aware of other economic benefits that an adviser or its related person would receive in this context.

11. Should we require advisers to disclose all compensation and fund expenses as proposed? Do commenters agree with the scope of the proposal? Why or why not?

We do not agree with the scope of this disclosure requirement, which we believe is overinclusive and could, for example, force an adviser to disclose proprietary or commercially sensitive information. The Commission should consider allowing advisers the flexibility to exclude such information from the required statement. Furthermore, we would recommend modifying the Proposal to provide that, with respect to amounts paid to related persons, the adviser can exclude amounts paid by the fund pursuant to an arm's length transaction in which the amount charged to the fund is commensurate with the market price for similarly situated entities and services.

12. Would the proposed content result in fund-level fee and expense disclosure that is meaningful to investors? Are there other items that advisers should be required to disclose in the fund table? Are there any proposed items that we should eliminate? Would more or less information about the fees and expenses charged to the fund be helpful for investors? Are there any revisions to the descriptions of fees that would make the proposed disclosure more useful to investors?

No, we do not believe that, as proposed, this disclosure would be meaningful to investors as the proposed granularity would require subjective interpretations to be made by each adviser, resulting in less standardized disclosures than those currently provided to investors. Instead, disclosure on these statements should be consistent with the methodology used for the fund's audited financial statements to ensure greater comparability.

The Commission should limit the fund-level disclosure only to compensation, fees and other amounts paid *directly* by the fund to the adviser. Sub-advisory fees, for example, are generally not paid directly to the sub-adviser by the fund, and we are concerned that by including sub-advisory fees, the Commission implies that indirect payments should also be captured. Moreover, the comparisons will not be meaningful to investors where, generally, intra-group sub-advisers are paid according to transfer pricing policies.

Furthermore, we would recommend allowing an adviser to exclude certain investment-related expenses (e.g., trading commissions) given the difficulty that hedge fund advisers in particular would have in producing this data for potentially millions of trades. Such expenses would most likely need to be estimated due to the elevated risk of calculation error.

13. Instead of the proposed approach, should we prescribe a template for the fund table? Would the increased comparability of a template be useful to investors? Would a template be flexible enough to accommodate changes in the types of fees and expenses as well as the types of offsets, rebates, or waivers used by private fund advisers? Would a template necessitate repeated updating as the industry evolves?

We do not believe that a template would be useful to investors and would agree with ILPA that "[t]his new rule should be principles based…without the need for SEC rulemaking to continually update a form or SEC-created template. We…would encourage the SEC not to introduce another fee template into the market."[73] In light of the potential variations in fees, expenses and performance among firms and different asset classes, the likelihood that such granular data will be quite technical and complex, and the inevitability of inconsistences among advisers in completing the template, a prescribed template would make it difficult for individual investors to effectively analyze the information provided and compare such information across funds and advisers (as contemplated in the Proposing Release). Investors, not the Commission, are in the best position to determine the manner and content of data provision that is most useful to them. As the Commission suggests, any Commission-prescribed templates may become out of date as industry practices evolve, and the process of amending the requirements and, subsequently, such templates, would result in greater inefficiencies for advisers and investors. As an alternative, however, the Commission should consider having the reporting reference the standards used for unaudited semi-annual financial statements. This would ensure consistency with the annual audited financial statement process, provide as close to an apples-to-apples comparison as is possible and reduce the overall level of burden for funds and advisers.

14. Omitted

15. The proposed rule would require an adviser to include the compensation paid to a related person sub-adviser in its quarterly statement. For private funds that have sub-advisers that are not related persons, should we require a single quarterly statement showing all adviser compensation (at both the adviser and sub-adviser levels)? In cases where a non-related person sub-adviser does not prepare a quarterly account statement in reliance on the adviser's preparation and distribution of the quarterly statement to the fund's investors, how would advisers reflect the compensation paid to the sub-adviser and its related persons? Do commenters agree that such compensation would be captured as a fund expense? Should we require a separate table covering these fees and expenses, as well as a separate table showing portfolio investment compensation paid to the sub adviser or its related person? How would advisers operationalize this requirement in these circumstances?

As noted above, sub-advisory fees are generally not paid directly by the fund. Therefore, to the extent that fees paid to a sub-adviser are paid by the adviser out of the adviser's fee (rather than directly by the fund), we do not believe that such fees are separately relevant to investors. Moreover, a requirement to disclose sub-advisory fee arrangements may damage U.S. investors' value for money as sub-advisers are unlikely to offer discounted or reduced fees to private funds if they know their sub-advisory fee will become available to their investor base.

The adviser should be able to disclose all such fees on a single statement, as multiple statements may be confusing to investors, and may not be important enough from the investor's perspective

[73] Institutional Limited Partners Association, Follow Up Letter to Chair Gensler (September 22, 2021).

(as opposed to simply having the total amounts disclosed) to justify the burden on advisers in preparing such additional statements.

16. **Should we adopt the proposed definitions of "related persons" and "control" as proposed? Are they too broad? Are the proposed definitions broad enough? Should we add former personnel of the adviser or its related persons to the proposed definition? If so, for how long after a departure from the adviser or its related persons should such personnel fall into the definition? Should the definition of related person include family members of adviser personnel or persons who share the same household with adviser personnel? Should the definition capture any person directly or indirectly controlled by the adviser's officers, partners, or directors (including any consulting firms controlled by such persons)? Should it capture operational partners, senior advisors, or other similar consultants of the adviser, the private fund, or its portfolio investments? Should we add any entity more than five percent of the ownership of which is held, directly or indirectly, by the adviser or its personnel? Should the definition include any person that receives, directly or indirectly, management fees or performance based compensation from, or in respect of, the fund; or any person that has an interest in the investment adviser or general partner (or similar control person) of the fund? If we adopt a different definition of "related person" than what is being proposed, should we use a different defined term (such as "related party") to avoid confusion given that the term "related person" is defined in Form ADV?**

The definitions of "related persons" and "control" should be consistent with the definitions of those terms used in the Form ADV, as proposed. As the Commission discusses in the Proposing Release, these definitions would appropriately limit their scope to only those entities or persons typically used to conduct a single advisory business.[74] Furthermore, because they are the same as the definition used in the Form ADV, advisers have experience assessing these terms as part of their disclosure obligations. Adopting a different definition could capture irrelevant persons or entities while creating unnecessary confusion for persons responsible for implementing these new requirements.

We believe the requirement to report amounts paid to any related person is an overinclusive standard. For example, each private fund itself could be considered a "related person" of the adviser, and so this requirement would appear to capture amounts such as dividends that are paid to the fund and therefore accruing 100% to the benefit of the fund's investors.

We encourage the Commission to provide specific exceptions to this requirement, such as exemptions for amounts paid to a fund itself and arms-length transactions in the marketplace.

17. **For purposes of the definition of "control," are the control presumptions appropriate in this context? Should we eliminate or modify any of the presumptions? For example, should we eliminate aspects of the definition that may capture passive investors who do not have the power to direct the management or policies of the relevant entity? Why or why not? Should we add any additional control presumptions? For example,**

[74] Proposing Release, *supra* note 3, at 16893.

should an entity be presumed to be controlled by an adviser to the extent the adviser has authority over the entity's budget or whether to hire personnel or terminate their employment?

The control presumptions should be consistent with those used in relation to the Form ADV, as advisers have experience applying this framework in the context of preparing responses to that form.

18. The proposed rule includes a non-exhaustive list of certain types of adviser compensation and fund expenses. Would this information assist advisers in complying with the rule? Should we add any additional types? If so, which ones and why?

No. The proposed granularity with respect to fees and expenses would require subjective interpretations to be made by each adviser, resulting in less standardized disclosures than those currently provided to investors. The disclosures required should be consistent with the requirements for audited financial statements instead.

19. Do private fund advisers or their related persons receive other economic benefits that the rule should require advisers to disclose in the quarterly statement? For example, should we require hedge fund advisers to disclose the dollar amount of any soft dollar or similar benefits provided by broker-dealers that execute trades for the funds, or any benefits provided by hedge fund prime brokers?

The Commission should not require hedge fund advisers to disclose the specific dollar amount of soft dollar or similar arrangements. It is standard practice for hedge fund advisers to disclose the existence of soft dollar arrangements, and, because advisers generally structure soft dollar arrangements to comply with the safe harbor under Section 28(e) of the Exchange Act,[75] we believe that investors are already provided sufficient protections under that provision.

20. Do commenters agree with the scope of the proposed definition of "performance-based compensation"? Should we specify the types of compensation that should be included in the definition? For example, should the definition specify that the term includes carried interest, incentive fees, incentive allocations, performance fees, or profit allocations?

As we have responded elsewhere, we believe that the types of compensation required to be disclosed should be consistent with the information contained in the audited financial statements. We are concerned that overly prescriptive requirements may compel a fund to disclose commercially sensitive information, which would ultimately raise the costs to the fund and harm investors.

21. Should we only require the table to disclose adviser compensation and fund expenses after the application of any offsets, rebates, or waivers, rather than before and after, as proposed? If so, why?

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[75] 15 U.S.C. 78bb(e).

If the offset, rebate or waiver is paid out of the adviser's performance-based compensation, it would be misleading to investors to reflect those figures as fund expenses. Moreover, for those funds in which conditional rebates are offered (such as if an investor remains in the fund at year-end), it would be difficult, if not impossible, to account for these in the fund-wide numbers.

22. Should we define offsets, rebates, and waivers? If so, what definitions should we use and why? Are there any types of offsets, rebates, and waivers that we should not require advisers to reflect in the fund table? If so, which ones and why? To the extent that offsets, rebates, or waivers are available to certain, but not all, investors, are there any operational concerns with reflecting and describing those offsets, rebates, or waivers in the fund-wide numbers presented in the quarterly statement? Are there alternatives we should use?

The Commission should allow advisers to use the general market understanding of these terms, rather than prescribe a specific definition. Furthermore, if the offset, rebate or waiver is paid out of the adviser's performance-based compensation, it would be misleading to investors to reflect those figures as fund expenses. Moreover, for those funds in which conditional rebates are offered (such as if an investor remains in the fund at year-end), it would be difficult, if not impossible, to account for these in the fund-wide numbers.

23. Omitted.

24. Should we require advisers to provide any additional disclosures regarding fees and expenses in the quarterly statement? In particular, should we require any disclosures from an investment adviser's Form ADV Part 2A narrative brochure (if applicable) to be included in the quarterly statement, such as more details about an investment adviser's fees?

No, the Commission should not require any additional disclosures, including those from the Form ADV. Investors should be provided a simple, straightforward accounting of activity in their account that is unobscured by excess information available elsewhere or otherwise unhelpful to understanding the information in the periodic statement. Investors have access to Form ADV and the fund's offering documents and are able to reference those documents as necessary.

25. Should we tailor the disclosure requirements based on fund type? For example, should the requirements or format for hedge funds differ from the requirements and format for private equity funds? Are there unique fees or expenses for types of funds that advisers should be required to disclose or otherwise list as a separate line item? If so, how should we define these types of funds for these purposes? For example, should we use the definitions of such terms used on Form ADV?

We believe that, instead of prescribing specific requirements, the Commission should adopt a principles-based approach that allows advisers the flexibility to present fees and expenses in a manner appropriate for each fund type, taking into account the specific needs of investors in these funds, as preferences can vary widely. To this end, we suggest that the Commission consider an approach consistent with the requirements for unaudited semi-annual financial statements.

26. Do any of the proposed requirements impose unnecessary costs or compliance challenges? Please provide specific data. Are there any modifications to the proposal that we could make that would lower those costs or mitigate those challenges? Please provide examples.

Yes, the proposed requirements collectively impose unnecessary and substantial costs as well as compliance challenges. The requirements are also significantly more onerous than is the case for registered investment companies that are only required to provide shareholders with annual audited and semi-annual unaudited financial statements. The semi-annual reports for registered investment companies are also not due until 60 days after the relevant period ends, rather than the shorter 45 days proposed as part of the Quarterly Statement Rule. As discussed in our response to Question 3, the Commission should reduce the frequency of reporting from quarterly to semi-annually and providing 60 days for the semi-annual disclosure and 120 days for the annual disclosure.

We believe the Commission has not fully considered the extent to which the Quarterly Statement Rule would present an undue burden on the resources of advisers. Advisers generally do not track fees and expenses with the level of granularity required by the Quarterly Statement Rule, particularly at the portfolio investment level, and it is likely that many advisers will need to implement significant changes to their accounting practices and systems (such as the development and use of bespoke software) in order to comply with the new requirements. Furthermore, investment-related expenses (e.g., trading commissions, financing costs, margin) can be significant and extremely difficult to track and record for funds with actively traded strategies.

Additionally, costs and risks associated with the new performance reporting requirements are likely to create unintended adverse consequences for investors. As just one example, many advisers have already committed to providing reports that adhere to other specific performance reporting standards such as GIPS – a reporting protocol requested by many pension plan investors and institutional investor consultants. The proposed new statements would demand such a substantial dedication of internal resources (from advisers' compliance functions as well as many others) that undoubtedly, many advisers would be unable to provide any form of requested but not required reporting. This would present a very real challenge to the institutional investors who have come to rely on such other reporting and have designed their own systems and evaluation tools around it.

In any event, one modification we would recommend is with respect to funds for which the U.S. dollar is not the base currency (as the rule requires reporting in U.S. dollars). The Commission should permit advisers to make disclosures in the base currency of the fund where the fund's base currency is not the U.S. dollar, or, in the alternative, permit the disclosure to be made applying a single exchange rate taken on the last day of the quarter for which the data is being reported. If advisers are not provided these options, advisers will face an extraordinarily high cost of compliance, as the provision of meaningful numbers would force advisers to create a separate process for managing the consistent and timely application of each spot exchange rate and would effectively have to run a set of shadow accounts to facilitate this reporting.

27. The proposed quarterly statement prescribes minimum fee and expense information that must be included. What are the benefits and drawbacks of prescribing the minimum disclosure to be included in the quarterly statement and otherwise permitting advisers to include additional information? Do commenters agree that we should allow advisers to include additional information? Would the inclusion of additional information affect whether investors review the quarterly statement?

In practice, we fully expect that investors would want advisers to continue to provide their existing reports and reconcile the periodic statement to existing reports in order to understand any discrepancies. This would be a superfluous use of resources for both investors and advisers, and we would therefore reiterate our view that information provided in the periodic statement should be consistent with that in the audited financial statements.

28. Certain advisers use management fee waivers where the amount of management fees paid by the fund to the adviser is reduced in exchange for an increased interest in fund profits. Because fund agreements often document such waivers with complex and highly technical tax provisions, should we provide guidance to assist advisers in complying with the proposed requirement to describe the manner in which they are calculated or specify a methodology for such calculations?

We do not believe that the Commission should provide such guidance. This issue is highly technical and guidance is not likely to improve understanding among the personnel likely to be responsible for compiling and reporting such information.

29. Should we permit advisers to exclude expenses from the quarterly statement if they are below a certain threshold? Alternatively, should we permit advisers to group expenses into broad categories and disclose them under single line item – such as "Miscellaneous Expenses" or "Other Expenses" – if the aggregate amount is de minimis relative to the fund's size? Why or why not?

While we generally agree with allowing advisers to exclude certain expenses that are not material to fund investors, we do not think that the Commission is best positioned to make the determination of what the threshold for exclusion should be. If the Commission does require the disclosure of all expenses, it should permit advisers to categorize and group expenses into categories in a manner that aligns with their own internal methods of tracking and accounting for such expenses, or otherwise permit the level of detail provided in the annual audited financial statements.

30. Omitted.

31. Should the table provide fee and expense information for any other periods? For example, should we require advisers to disclose all adviser compensation and fund expenses since inception (in addition to adviser compensation and fund expenses allocated or paid during the applicable reporting period)? If so, should we require since inception information only for certain types of funds, such as closed-end private funds, and not for other types of funds, such as open-end private funds?

We believe that the table should only cover the current period, or if information for fees and expenses paid since inception are included in the final rule, funds already in existence on the effective date of the rule should be excluded from the requirement. If advisers to such funds were required to collect and process information from prior years, this would be an enormously expensive undertaking, particularly where the fund has been in existence for several years. Moreover, the specific information may not be comparable over longer periods because of changes in accounting guidance and market practice. These challenges are exacerbated by the need to collect the data on amounts paid to related persons, which may be impossible in certain circumstances.

32. **We recognize that certain private fund advisers may already provide quarterly account or similar statements to investors, such as advisers that rely on an exemption from certain disclosure and recordkeeping requirements provided by U.S. Commodity Futures Trading Commission Regulation 4.7. How often are private fund advisers separately required to provide such quarterly statements, and how often do they do so even when not required? Would there be any overlap between the proposed quarterly statement and the existing quarterly account or similar statements currently prepared by advisers?**

The Commission should assess current disclosures provided to investors before concluding they are inadequate and thus that the additional disclosure required under the Quarterly Statement Rule is necessary. We expect that there will be significant overlap between the proposed quarterly statement and similar statements already provided to investors, however, the granularity of the requirements under the Quarterly Statement Rule would require each adviser to make subjective interpretations that could result in less standardized disclosures than those currently provided to investors. Accordingly, the requirements should be consistent with audited financial statements already provided to investors.

33. **Would the proposed rule provide portfolio investment compensation disclosure that is meaningful to investors? Should the rule require advisers to disclose additional or different information in the portfolio-investment table? Would more information about the fees and expenses charged to portfolio investments be helpful for investors?**

The definition of "portfolio investment compensation" is overinclusive in that by including amounts allocated or paid to a related person of the adviser, this would presumably include amounts allocated or paid to the private fund (or its affiliated entities). Accordingly, any amounts paid to the fund would be technically reportable even though investors receive the full benefit. For example, a loan fund receiving coupon payments from portfolio companies to which it has lent money, would be potentially in scope of the reporting requirement as regards the coupon payments collected from portfolio companies. Therefore, we believe that, at a minimum, the Commission should carve out amounts paid to the fund, or other funds, by the portfolio investment.

Additionally, an adviser would have to disclose portfolio investment compensation paid in connection with transactions involving public companies with respect to which there is no control relationship between the company and the adviser/its related persons. We believe this would result in the provision of significant amounts of information that would not be useful to investors in relation to understanding potential conflicts of interest. The Commission should explicitly carve out compensation paid in such circumstances.

34. Omitted.

35. Is the proposed definition of "portfolio investment" clear? Should we modify or revise the proposed definition? For example, should we define "portfolio investment" as any person whose securities are beneficially owned by the private fund or any person in which the private fund owns an equity or debt interest? Alternatively, should we define "portfolio investment" as any underlying company, business, platform, issuer, or other person in which the private fund has made, directly or indirectly, an investment? Should we permit advisers to determine, in good faith, which entity or entities constitute the portfolio investment for purposes of the quarterly statement rule? For example, a fund of funds may indirectly invest in hundreds of issuers or entities. Depending on the underlying structure, control relationship, and reporting, the fund of funds' adviser may have limited knowledge regarding such underlying entities or issuers. Should we exclude such entities or issuers from the definition of portfolio investment for such advisers? Is there a different standard or test we should use? Should we require such adviser to conduct a reasonable amount of diligence consistent with past practice and/or industry standards? Why or why not?

We would recommend modifying the definition of "portfolio investment" to make it explicitly clear that it only applies to any issuer of *securities* in which the private fund has *directly* invested and in which the private fund owns 25% or more of any class of such issuer's voting shares.

We believe that the present formulation, which includes entities *and* issuers (even though the latter properly describes the person offering the securities acquired by the private fund) and indirect investments (which could theoretically include investments through passive exchange-traded funds or through an investment in another private fund), as well as passive non-controlling investments in which there is no ability for the adviser or its related persons to influence the activities of the portfolio investment, is overbroad and is likely to capture arrangements in which the conflict of interest concerns underlying the Commission's proposal are not as significant.

Furthermore, given, as the Commission acknowledges, that a fund of funds may indirectly invest in countless issuers for which the adviser has limited knowledge, if the Commission adopts the "indirect" formulation of this Proposal, it should exclude, at a minimum, indirect investments made by a fund into another fund.

36. As discussed above, to the extent a private fund enters into a negotiated instrument, such as a derivative, with a counterparty, we would not consider the private fund to have made an investment in the counterparty. Do commenters agree with this approach? Why or why not? Should we adopt a different approach for derivatives or other similar instruments generally? For purposes of determining whether the fund has made an investment in an issuer or entity, should we only include equity investments? Should we exclude derivatives? Why or why not? How should exchange-traded (i.e., not negotiated) derivatives, including swaps and options, be treated for purposes of the rule?

We agree that a private fund investing in a derivative should not be considered to have made an investment in the counterparty and believe that the Commission should also deem that a private fund investing in a derivative has not made an investment in the underlying issuer or entity.

37. The proposed definition of portfolio investment would not distinguish among different types of private funds. Is our approach in this respect appropriate or should we treat certain funds differently depending on their strategy or fund type? If so, how should we reflect that treatment? For example, should we modify the definition with respect to a real estate fund to reflect that such a fund generally invests in real estate assets, rather than operating companies? Because a secondaries fund may indirectly invest in a significant number of underlying operating companies or other assets, should we limit the "indirect" component of the definition for such funds (or any other funds that may have indirect exposure to a significant number of companies or assets)? Why or why not? Would additional definitions be appropriate or useful? Should the proposed rule define the term "entity" and/or "issuer"? If so, how? Should the proposed rule treat hedge funds, liquidity funds, and other open-end private funds differently than private equity funds and other closed-end private funds?

We would observe as a general matter that this aspect of the Quarterly Statement Rule seems to have been developed with private equity-type investments in mind, yet it would likely capture a number of asset classes for which such a characterization would be inappropriate.

While it would not address many of problems associated with the Commission's approach, we would urge the Commission to consider, as a starting point, modifying the definition to refer only to an *issuer* of *securities* in which the private fund has directly invested to appropriately reflect the scope of the Advisers Act (which governs persons providing advice about *securities*[76]) and to accord with the common understanding of these terms under the securities laws.

38. Should we adopt the approach with respect to portfolio-investment compensation as proposed? Do commenters agree with the scope of the proposal? Why or why not?

Please see our response to Question 35.

39. Omitted.

40. Should we require advisers to list each type of portfolio-investment compensation as a separate line item as proposed? Would this level of detail be helpful for investors with respect to portfolio-investment reporting? Given that many funds require a management fee offset of all portfolio-investment compensation, is this level of detail necessary or useful to investors? Should we instead require advisers to provide aggregate information for each covered portfolio investment?

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[76] *See, e.g.*, 15 U.S.C. 80b–2(a)(11) (defining an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities").

The Commission should permit advisers to provide aggregate information for each covered portfolio investment, rather than disclose it as separate line items.

41. Should the rule permit advisers to use project or deal names or other codes, and if so, what additional disclosures are necessary for an investor to understand the nature of the conflicts?

Without prescribing specific methods, the Commission should provide advisers the general flexibility to refer to such projects or deals in a manner consistent with the adviser's and the fund's confidentiality obligations.

42. We considered only requiring advisers to disclose the amount of portfolio investment compensation after the application of any offsets, rebates, or waivers, rather than before and after. We believe the proposed approach would be more helpful for investors because investors would have greater insight into the compensation advisers initially charge and the amount they ultimately retain at the expense of the private fund and its investors. Do commenters agree? Why or why not?

Based on our experience, we do not believe that investors would find this information useful, particularly where certain types of compensation are fully offset.

43. Would information about a firm's services to portfolio investments be helpful for investors? Are there any elements of the proposed requirements that firms should or should not include? If so, which ones and why?

To the extent that investors find this information helpful, it would be more appropriately included in the fund's offering memorandum.

44. We considered requiring advisers to disclose the total portfolio-investment compensation for the reporting period as an aggregate number, rather than providing the amount of compensation allocated or paid by each covered portfolio investment as proposed. However, we believe that investment-by-investment information would provide investors with greater transparency into advisers' fee and expense practices and thus be more helpful for investors. Do commenters agree? Should we require advisers to report a consolidated "top-line" number that covers all covered portfolio investments?

We believe that a consolidated number would be more user-friendly to investors in that it would clearly disclose the total amount the adviser is receiving from portfolio investments, rather than requiring investors to compute these figures themselves. Such amounts could vary widely depending on the particular portfolio investment (especially in asset classes other than private equity) and thus may not be as informative on an individual basis as the consolidated amount would be.

45. Omitted.

46. Omitted.

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47. Should we require advisers to disclose how they allocate or apportion portfolio investment compensation among multiple private funds invested in the same covered portfolio investment? If so, how should the portfolio investment table reflect this information?

We do not believe this is necessary given that we would expect adviser expense allocation policies and procedures, which would generally be available to investors, to address this issue.

48. Certain advisers have discretion or substantial influence over whether to cause a fund's portfolio investment to compensate the adviser or its related persons. Should the requirement to disclose portfolio-investment compensation apply only to advisers that have such discretion or authority? Should such requirement apply if the adviser is entitled to appoint one or more directors to the portfolio investment's board of directors or similar governing body (if applicable)? Is there another standard we should require?

Yes, we believe that the requirement should only be limited to advisers that have such discretion or authority to cause a portfolio investment to compensate the adviser or its related persons, as those are the circumstances in which conflicts issues would arise. As noted in our response to Question 35, the definition of "portfolio investment" should be limited to issuers in which the private fund owns 25% or more of any class of voting shares. We do not believe that the mere appointment of one director should be enough to trigger the compensation disclosure requirement. A single director would likely be unable to itself compel the portfolio investment to cause the payment of compensation to the adviser. Furthermore, advisers might be incentivized to avoid seeking board representation, which would ultimately be to the detriment of the fund and its investors.

49. We recognize that certain private funds, such as quantitative and algorithmic funds and other similar funds, may have thousands of holdings and/or transactions during a quarter and that those funds typically do not receive portfolio investment compensation. While the proposed rule would not require an adviser to include any portfolio investment that did not pay or allocate portfolio-investment compensation to the adviser or its related persons during the reporting period in its quarterly statement, these advisers would need to consider how to identify such portfolio investment's payments and allocations for purposes of complying with this disclosure requirement. Should the rule provide any full or partial exceptions for such funds? Should we require investment-level disclosure for quantitative, algorithmic, and other similar funds only where they own above a specified threshold percentage of the portfolio investment? For example, should such funds only be required to provide investment-level disclosure where they own 25% or more ownership of any class of voting shares? Alternatively, should we use a lower ownership threshold, such as 20%, 10%, or 5%? Should we adopt a similar approach for all private funds, rather than just quantitative, algorithmic, and other similar funds? If so, what threshold should we apply? For instance, should it be 5%? Or 10%? A higher percentage?

The Commission should use a 25% ownership threshold for all private funds, not just quantitative, algorithmic and similar funds, to correspond with the thresholds used in connection with the Proposal's control presumption.

50. Should we exclude certain types of private funds from these disclosures? If so, which funds and how should we define them? For example, should we exclude private funds that only hold (or primarily hold) publicly traded securities, such as hedge funds?

The Commission should provide advisers with a principles-based approach that allows them the flexibility to make such disclosures as the adviser believes are material to the relevant investors. Funds that primarily hold publicly traded securities should be excluded from the rule, as the conflicts the Commission is seeking to address are generally not present in such funds.

51. Omitted.

52. Omitted.

53. Omitted.

54. The proposed rule would require the adviser to disclose the amount of portfolio investment compensation attributable to the private fund's interest in the covered portfolio investment that is paid or allocated to the adviser and its related persons. Should we require disclosure of portfolio compensation paid to other persons (such as co investors, joint venture partners, and other third parties) to the extent such compensation reduces the value of the private fund's interest in the portfolio investment?

No, the Commission should not require such disclosure. Portfolio compensation paid to third parties, whether they are joint venture partners or otherwise, does not raise the types of conflicts the Commission cites as its rationale for the Proposal and would leave investors with the unjustified and misleading impression that these payments are somehow tainted by conflict or that they should be offset by fee waivers.

55. Should we allow flexibility in the words advisers use, as proposed, or should we require advisers to include prescribed wording in disclosing calculation methodology? If the latter, what prescribed wording would be helpful for investors? Does the narrative style work or are there other presentation formats that we should require?

We do not believe that a prescribed approach would be useful to investors. Rather, the Commission should provide the flexibility for an adviser to tailor any such disclosure to reflect the actual methodology used.

56. Should we provide additional guidance or specify additional requirements regarding what type of disclosure generally should or must be included to describe the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated? For example, should we provide sample disclosures describing various calculations? Should the rule require advisers to restate disclosures from offering memoranda (if applicable) regarding the manner in which expenses, payments,

allocations, rebates, waivers, and offsets are calculated in the quarterly statement? Do commenters believe that advisers would prefer to restate offering memoranda disclosures rather than drafting new disclosures to avoid conflicting interpretations of potentially complex fund terms? Should the rule only require advisers to provide a cross reference to the language in the fund's governing documents regarding this information (e.g., identifying the relevant document and page or section numbers)?

The Commission should allow advisers the flexibility to provide such disclosures as the adviser believes is reasonably necessary for an investor to understand the information being provided. To the extent that the Commission prescribes specific requirements, advisers should be permitted to cross reference language in the fund's governing documents in order to avoid confusion as well as the risk of any unintentional discrepancies.

57. Would providing cross references, as proposed, to the relevant sections of the private fund's organizational and offering documents be helpful for investors? Would it permit investors to "cross check" or evaluate the adviser's calculations? Are there other alternatives that would achieve our objectives?

We do not believe this would be helpful, as it would clutter up the periodic statement and make it more difficult for investors to read and digest the information contained therein. We believe that private fund investors have the requisite sophistication to "cross check" the statement against the relevant provisions in the fund documents.

58. Should the proposed rule require advisers to include performance information in investor quarterly statements? Why or why not?

No, we do not believe that advisers should be required to include performance information in the periodic statement, as this will serve only to add length and complexity to the statement. Investors ask for and receive a fund's performance history prior to making an investment decision, and those materials are already properly regulated under the Marketing Rule. Once an investment is made, the investor would require only the performance for the latest reporting period and could request other prior performance data if necessary. Therefore, we would urge the Commission, if it adopts this requirement, to require the inclusion of performance information *solely for the reporting period*.

Furthermore, if the Commission requires the inclusion of performance information in the periodic statement, it should allow an adviser to disclose such information in accordance with the standards outlined in the Marketing Rule. The Marketing Rule reaffirms the obligation of advisers to provide accurate, non-misleading performance information to investors, and the Commission has not offered any suggestion that the requirements of the Marketing Rule would be inadequate to protect private fund investors. As full compliance with the Marketing Rule will be required by November 2022, many registered advisers are in the process of updating their policies and procedures regarding the provision of information to investors. Therefore, harmonizing the two rules to the extent feasible will facilitate greater compliance with both, as well as reduce investor confusion.

The overly-prescriptive performance information requirements do not account for the variation between funds and between investors in such funds. Many funds offer several types of interests to accommodate the specific needs of individual investors, including classes with different fee and liquidity arrangements. Such investors therefore need to work out with advisers reporting on the performance information that is appropriate in light of their experience as an investor in the applicable fund. The Commission itself notes in the Proposing Release that due to the varying types of complicated private fund structures and complex financing mechanisms, an adviser (particularly an adviser to illiquid funds) may need to make certain assumptions when calculating performance.[77] If the Commission permitted advisers the flexibility to calculate and present performance in a manner tailored to the fund/investors, investors would still have appropriate protections as advisers would still be required to disclose such assumptions in order for the data to not be misleading. It would be more misleading to investors to prescribe a standardized approach to performance reporting as the Commission has done in the Proposal, particularly given the artificial constructs required, such as consolidation of multiple funds investing in similar assets and the presumption that credit lines were not used when in fact they were.

Additionally, to the extent the Commission-mandated metrics obscure and confuse the actual performance as presented to investors, advisers may have to assume additional costs to provide corrective or clarifying information, costs that would be unnecessary if advisers could continue to provide investors only that information which is relevant to them. Such costs (and the risks of liability associated with providing unclear information to investors) are exacerbated for advisers that have contractually committed to provide performance using alternative standards, such as GIPS compliant performance reporting. Moreover, even if advisers are able to incur the additional cost of providing corrective or clarifying information, the Proposal creates a material risk of investor confusion, thus exposing the adviser to potential Rule 10b-5 liability and/or state law claims.

Finally, we would note that while the Proposal distinguishes between the policy goals of the performance reporting elements of the Marketing Rule and the Quarterly Statement Rule (the former being concerned with prospective fund investors and the latter current fund investors), it states that "current investors in a fund rely on this [fee, expense and performance] information in determining whether to invest in subsequent funds and investment opportunities with the same adviser."[78] We think this underscores that harmonization of the Quarterly Statement Rule to the Marketing Rule is a far more logical approach.

59. Should the proposed rule require advisers to determine whether a private fund is a liquid or illiquid fund and provide performance metrics based on that determination? Alternatively, should the rule eliminate the definitions and give advisers discretion to provide the proposed performance metrics that they believe most accurately portray the fund's returns?

The rule should eliminate the definitions and give advisers discretion to provide metrics that investors would find most useful. If the Commission ultimately adopts these definitions, then the

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[77] Proposing Release, *supra* note 3, at 16900.

[78] *Id*. at 16938.

Commission should treat an adviser's election to categorize a fund as illiquid or liquid as presumptively valid so long as the adviser applies it consistently with respect to the particular fund.

60. Should we define "illiquid fund" and "liquid fund" as proposed or are there alternative definitions we should use? Are there other terms we should use for these purposes? For example, should we refer to the types of funds that would provide annual net total returns under the rule as "annual return funds" and those that would provide internal rates of return and a multiple of invested cash under the rule as "IRR/MOIC funds"?

See our response to Question 59.

61. Omitted.

62. Omitted.

63. Omitted.

64. Will advisers be able to determine whether a private fund it manages is a liquid or illiquid fund? For example, how would an adviser classify certain types of hybrid funds under the proposed rule? Should the rule include a third category of funds for hybrid or other funds? If so, what definition should we use? Should we amend the proposed definitions if we adopt a third category of funds (e.g., should we revise the definition of "liquid fund" given that the proposal defines "liquid fund" as any private fund that is not an illiquid fund)? If a fund falls within the third category, should the rule require or permit the private fund to provide performance metrics that most accurately portray the fund's returns?

See our response to Question 59.

65. Omitted.

66. How would an adviser to a private fund with an illiquid side pocket classify the private fund under the proposed rule's definitions for liquid and illiquid funds? For example, would the adviser treat the entire private fund as illiquid because of the side pocket? Why or why not? Should we permit or require the adviser to classify the side pocket as an illiquid fund, with the remaining portion of the private fund classified as a liquid fund?

The Commission should provide the adviser with the flexibility to classify the side pocket, if material to the relevant fund as a whole, as liquid or illiquid, depending on whether such classification would, in the calculation of performance required by the rule, provide investors with more meaningful information and would not otherwise be misleading. The classification could vary from one adviser to another depending on the circumstances, as well as over time within the same fund. For example, a side pocket investment could represent less than 1% of the fund's NAV at inception, but, in liquidation, it could be greater than 90% of the remaining assets. Advisers should have flexibility to allow reporting to evolve in response to changing circumstances to provide the most useful information to investors.

67. Instead of requiring advisers to show performance with equal prominence, should the proposed rule instead allow advisers to feature certain performance with greater prominence than other performance as long as all of the information is included in the quarterly statement? Why or why not?

The Commission should not prescribe specific presentation requirements, but rather allow advisers the flexibility to present performance information in accordance with the principles-based approach adopted in the Marketing Rule.

68. Should we require advisers to provide annual net total returns for liquid funds, as proposed? Would showing annual net total returns for each calendar year since a private fund's inception be overly burdensome for older funds? Would performance information that is more than 10 years old be useful to investors? Why or why not?

The Commission should not adopt such a requirement, but rather allow individual investors to decide for themselves whether this information is important to them. If an investor has a particular interest, it can request this data from the adviser.

As a general matter, we do not believe that performance information that is more than 10 years old would be useful to investors, as such performance may have been achieved by different personnel and pursuant to an investment strategy that was subsequently modified and thus differs in meaningful ways from the experience of current investors in the fund, and also is certain to reflect market conditions that differ from present-day conditions. In some instances, such information may not have been retained.

69. Omitted.

70. The proposed rule would require advisers to provide performance information for each calendar year since inception and over prescribed time periods (one-, five-, and ten-year periods). Should the proposed rule instead only require an adviser to satisfy one of these requirements (i.e., provide performance each calendar year since inception or provide performance over the prescribed time periods)? For funds that have not been in existence for one of the prescribed time periods, should the proposed rule require the adviser to show the average annual net total return since inception, instead of the prescribed time period?

The Commission should only require advisers to include performance information for the reporting period (i.e., the six-month period for the semi-annual statement and the relevant fiscal year for the annual statement).

In the adopting release for the Marketing Rule, the Commission acknowledged that "requiring advisers to provide performance results of private funds over one-, five-, and ten-year periods in advertisements *will not provide investors with useful insight* into how the advertised portfolio(s) performed during different market or economic conditions" (emphasis added).[79] That same logic is applicable to the presentation of performance results in the periodic statement. To the extent

[79] Marketing Rule, *supra* note 5, at 13073.

that the Commission seeks to require performance information over particular time periods, it should provide advisers the flexibility to determine such time periods as is appropriate to provide useful information to investors and in a manner that would otherwise not be misleading.

71. The proposed rule would require advisers to provide average annual net total returns for the private fund over the one-, five-, and ten- calendar year periods. However, the proposal would not prohibit advisers from providing additional information. Should we allow advisers to provide performance information for annual periods other than calendar years?

As with the Marketing Rule, the Commission should not prescribe specific time periods, but allow private fund advisers the flexibility to present private fund performance in a manner that is most meaningful to investors, subject to the general antifraud provisions of the Federal securities laws.

72. Omitted.

73. Omitted.

74. To the extent certain liquid funds quote yields rather than returns, should such funds be required or permitted to quote yields in addition to or instead of returns?

The Commission should permit advisers and their funds' investors the flexibility to determine whether or not the presentation of yields rather than, or in addition to, returns would present investors with more meaningful and relevant data as to fund performance, rather than the Commission prescribing any additional requirements.

75. Omitted.

76. Omitted.

77. Omitted.

78. Although some investors receive certain annual performance information about a private fund if that fund is audited and distributes financial statements prepared in accordance with U.S. GAAP, we believe that the proposed rule's performance information would be helpful for private fund investors because it would require performance information to be reported at more frequent intervals in a standardized manner. Do commenters agree? To the extent there are differences (e.g., the requirement that performance be computed without the impact of any fund-level subscription facilities), would investors find this confusing? Would disclosure regarding these differences help to alleviate investor confusion?

AIMA does not agree that the performance information requirement, as proposed, would be helpful for private fund investors. Investors generally get monthly performance statements from advisers, as well as other types of risk/performance reporting as agreed with and tailored for the investor base. More frequent reporting, as required by the Quarterly Statement Rule, is not likely to provide any useful additional information to investors beyond the performance reporting investors are already receiving from advisers. The Quarterly Statement Rule would simply add additional expenses in connection with the preparation of investor reports – expenses that will ultimately be passed on to the investors.

Given that the Commission recognizes that there might be differences between the new disclosure requirements and existing investor disclosures, even if it does ultimately require such reporting at more frequent intervals, it should permit advisers to compute and present performance in the same manner as in any financial statement that it already provides investors. As the Commission suggests, investors, even with disclosures, may find these discrepancies confusing, especially if they are already accustomed to receiving performance information in a particular manner.

79. Would investor confusion or other concerns arise from requiring performance information in the quarterly statement as proposed? What, if any, burdens would be associated with this aspect of the proposed rule? How can we minimize any associated burdens while still achieving our goals?

Yes. See our response to Question 78 above.

80. Omitted.

81. Omitted.

82. Omitted.

83. The Global Investment Performance Standards ("GIPS") are a set of voluntary standards for calculating and presenting investment performance. For purposes of calculating an illiquid fund's performance under the proposed rule, are there any elements found in the GIPS standards that we should require? For example, should we require advisers to disclose composite cumulative committed capital, or should we require advisers to disclose performance with and without the impact of subscription facilities? Are there any definitions we should revise or propose to be consistent with the definitions used in the GIPS standards? For example, the GIPS standards define "internal rate of return" as the return for a period that reflects the change in value and the timing and size of external cash flows and "multiple of invested capital" as the total value divided by since inception paid-in capital.95 If we were to adopt such definitions, do commenters believe that such definitions would result in different performance numbers for illiquid funds, as compared to the performance numbers that advisers would disclose under the proposed definitions? Why or why not? Please provide examples.

No, advisers should not be *required* to comply with some or all of the GIPS standards.

84. We recognize that advisers and their related persons typically invest in private funds on a "fee-free, carry-free" basis (i.e., they are not required to pay management fees or performance-based compensation). When calculating a fund's performance, how should such interests be taken into account? Should we require advisers to exclude such interests from the calculations, especially the net performance figures?

The Commission should permit advisers the flexibility to exclude such interests to the extent that they make the performance figure more meaningful to investors and would otherwise not be misleading.

85. The proposed rule would require advisers to calculate the various performance measures without the impact of any fund-level subscription facilities. Do commenters agree with this approach? Should the proposed rule require advisers to provide the same performance measures with the impact of fund-level subscription facilities? Why or why not? The proposed rule does not prohibit advisers from providing the same performance measures with the impact of fund-level subscription facilities. Should we prohibit advisers from doing so?

No, AIMA does not agree with this approach. The Commission should instead adopt a principles-based approach, in accordance with the Marketing Rule, that would allow each adviser to determine whether the presentation of performance measures, with or without the impact of fund-level subscription facilities, would be false or misleading to investors in the applicable fund.

86. Omitted.

87. Omitted.

88. Omitted.

89. Omitted.

90. Should we define the phrases "unrealized portion of the illiquid fund's portfolio" and "realized portion of the illiquid fund's portfolio"? For example, should we define the realized portion to include not only completely realized investments but also substantially realized investments to the extent the fund's remaining interest is de minimis? Why or why not?

The Commission should not adopt specific definitions, but rather leave it to the adviser to determine the difference between the realized and unrealized portion of a portfolio based on the facts and circumstances of the portfolio/investment strategy, and provided that the methodology underlying such determination is appropriately disclosed to investors.

91. Omitted.

92. The proposed rule would require advisers to provide cumulative performance reporting since inception of the illiquid fund each quarter. Is this the right approach? Should the proposed rule require performance since inception for each quarter or on an annual basis? Should the proposed rule remove the "since inception" requirement for quarterly reports and instead require performance for each quarter of the current year, and cumulative performance for the current year? If so, why or why not?

See our response to Question 58.

93. Should we prescribe specific periods for illiquid fund performance reporting? For example, should we prescribe one-, five-, and/or ten-year time periods? Instead, should we require that advisers always present performance since inception as proposed? Are there other periods for which we should require the presentation of performance results? Are there any specific compliance issues that an adviser would face in generating and presenting performance results for the required period? For example, would advisers have the requisite information to generate or support performance figures for older funds from the proposed recordkeeping requirements and/or performance presentation requirements? If not, should we provide an exemption for advisers that lack such information?

With respect to the 1-, 5- and 10-year presentation, see our response to Question 70.

94. Liquid funds often have longer terms than illiquid funds. To the extent an illiquid fund has been in existence for an extended period of time, such as more than ten years, should the rule prescribe specific periods for performance reporting for such funds (e.g., one-, five-, and/or ten-year time periods)?

As we have commented elsewhere, registered private fund advisers are in the process of preparing to comply with, or have already begun complying with, the new Marketing Rule. The Marketing Rule explicitly does not require private fund advisers to adhere to the prescribed time period provisions of the Proposal on the basis that requiring advisers to provide private fund performance results in that manner would not provide investors with "useful insight" into how the advertised portfolio performed.[80] It is unclear why the logic behind that decision does not apply to the performance reporting here, and the Commission should provide advisers with the same level of discretion to present performance time periods in a manner that is relevant and not otherwise misleading to investors.

95. Omitted.

96. Omitted.

97. As noted above, we would generally interpret the phrase computed without the impact of fund-level subscription facilities to require advisers to exclude fees and expenses associated with the subscription facility, such as the interest expense, when calculating net performance figures and preparing the statement of contributions and distributions. Do commenters agree with this approach? Should we require advisers to include such amounts instead? Are there other assumptions advisers would need to make in calculating performance information that the rule should address?

No, we do not agree with this approach, which provides purely hypothetical and misleading results, rather than reflecting an investor's actual experience.

98. Omitted.

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[80] Marketing Rule, *supra* note 5, at 13073.

99. The statement of contributions and distributions generally reflects aggregate, fund-level numbers. Should we also require a statement of contributions and distributions for each underlying investment? Would a statement of each investment's cash flows be useful to investors? Why or why not? Would such a requirement be too burdensome for certain advisers, especially advisers to private funds that have a significant number of investments? Should this requirement only apply to certain types of funds, such as private equity, venture capital, or other similar funds that may invest in operating companies?

A statement of contributions and distributions on anything other than a fund-level basis would be extraordinarily burdensome and would not provide investors with useful information that would not already be sufficiently provided in the aggregate numbers.

100. Should we provide further guidance or specify requirements on how advisers generally should or must present performance? For example, should we require advisers to present the various performance metrics with equal prominence as proposed? Should we require advisers to present performance information in a format designed to facilitate comparison? Should we provide additional guidance or requirements regarding how an adviser should or must calculate the proposed performance metrics? Is there additional information that we should require advisers to disclose when presenting performance?

See our response to Question 67.

101. Should we provide further guidance or specify requirements in the rule on how advisers generally should or must treat taxes for purposes of calculating performance? For example, should the rule state that advisers may exclude taxes paid or withheld with respect to a particular investor or by a blocker corporation (but not the illiquid fund as a whole)?

See our response to Question 58.

102. Should we require advisers to disclose the criteria used and assumptions made in calculating the performance as part of the quarterly statement as proposed? Is this approach too flexible? Should we instead prescribe required disclosures?

The Commission should only require the adviser to provide sufficient information to enable investors in the fund to understand the criteria used and assumptions made in calculating performance. This would align this requirement with the condition the Commission imposed on advisers in the Marketing Rule with respect to the presentation of hypothetical performance in advertisements, which the Commission recognized allowed advisers to tailor this additional information to the intended audience.[81] It would not make sense to subject the actual performance data required here to more substantial disclosure requirements than hypothetical performance data under the Marketing Rule. Furthermore, as with the Marketing Rule, providing advisers with

81 Marketing Rule, *supra* note 5, at 13083.

a more flexible approach would allow them to consider the intended audience, i.e., private fund investors with a generally greater level of sophistication to understand the calculations and assumptions underlying the performance data.

103. Omitted.

104. Because we propose to require an adviser to provide these disclosures as part of each quarterly statement, investors would receive these disclosures quarterly. Would providing these disclosures every quarter reduce their salience? Should we require these disclosures only as part of the first quarterly statement that an adviser sends to an investor with amendments if the criteria used or assumptions made in calculating performance change? Should we permit hyperlinking to these disclosures after the initial quarterly statement?

See our response to Question 58.

105. Should we require advisers to prepare and distribute statements to clients at least quarterly, or should we prescribe a different frequency? For example, should we require monthly, semi-annual, or annual statements? Should we mandate the same delivery frequency for all proposed statements under the rule? How would each of these approaches affect comparability and effectiveness of the information in those statements? Would a quarterly reporting obligation require advisers to value the fund's investments more frequently than advisers currently do? We understand that advisers may use a fund administrator or another person to distribute the quarterly statement. Is the proposed definition of "distribute" broad enough to capture a fund administrator or another person acting under the direction and control of the adviser sending the quarterly statement on the adviser's behalf? If not, should we broaden the definition? Instead of changing the definition of "distribute," should we require the adviser to distribute the quarterly statement, unless it has reason to believe that another person has distributed a required statement (and has a copy of each such statement distributed by such other person)?

With respect to frequency of preparation and delivery of periodic statements, please see our response to Question 3.

In relation to valuations, we would note generally that private funds conduct a valuation of the fund's assets (including hard-to-value level 3 assets) annually for purposes of the financial statement and for each dealing day. Closed-end funds (and open-end funds with annual or semi-annual dealing days) will therefore typically value assets on an annual (or semi-annual, if applicable) basis. Therefore, a quarterly reporting obligation would either require more frequent valuations for many funds or result in information that is unhelpful to investors.

106. The proposed rule would require advisers to distribute the quarterly statement within 45 days of a calendar quarter end. Is this period too long or too short for an adviser to prepare the quarterly statement while also ensuring timely delivery to investors? Should we instead adopt a flexible delivery standard, such as a requirement that the adviser distribute the quarterly statement "promptly"? Why or why not? If we were to

adopt a prompt delivery standard, should we define "promptly"? If so, how? If we should not define "promptly," should we instead interpret that term to mean as soon as reasonably practicable?

The proposed 45-day period is too short, particularly in light of the substantial information required under the Quarterly Statement Rule to be included on the statement. In addition to, as we have discussed, requiring the statements to be distributed no more frequently than on a semi-annual basis, advisers should be required to distribute the statement within no less than 60 days of the end of the reporting period.

107. Omitted.

108. Omitted.

109. Omitted.

110. Omitted.

111. Omitted.

112. The proposed rule would require fee and expense reporting based on a fund's calendar quarter and performance reporting based on a liquid fund's calendar year. Should we instead use "fiscal quarter" and "fiscal year"? Why or why not?

The Commission should require reporting based on the fund's "fiscal year" in accordance with typical fund practices, as well as the requirements applicable to reports sent to registered fund shareholders.

113. Are there certain types of advisers or funds that should be exempt from distributing the quarterly statement to investors? If so, which ones and why? Are there certain types of advisers or funds that should be required to distribute quarterly statements to investors? If so, which ones and why?

The Quarterly Statement Rule should exempt funds of one, as many of the proffered policy justifications underlying the rule would not be relevant in a single-investor vehicle, in which the investor is likely to have more favorable and heavily negotiated economics and transparency. The Quarterly Statement Rule should also exempt insider-only funds, sub-advisory mandates, funds in liquidation and funds where the adviser plays no role in the valuation of the assets. Lastly, funds that already provide audited financial statements and monthly or quarterly NAV statements to investors (pursuant to CFTC Rule 4.7) should be exempted.

114. Instead of requiring advisers to distribute the quarterly statement to investors, should we require advisers to only distribute or make the quarterly statement available to investors upon request? Despite the limitations of private fund governance mechanisms, as discussed above, should we require advisers to distribute the quarterly statement to independent members of the fund's LPAC, board, or other similar governance body?

Given that investors may already be receiving similar statements pursuant to an agreement with the adviser or another regulatory requirement, advisers and investors should be provided the flexibility to determine when the provision of the statement would be useful to the investor. Furthermore, requiring distribution of the statement to a governance body may not be useful to all investors to the extent that individual investors have differing informational preferences.

115. Omitted.

116. Should we revise the definition of "distribute" expressly to include distribution by granting investors access to a virtual data room containing the quarterly statement? Why or why not?

To the extent that some advisers may find the current definition, which requires that the statement be *sent* to investors, confusing, it might be beneficial to explicitly clarify (whether in the definition or elsewhere) that providing investors access to a data room or online client portal containing the statement would be sufficient. It is likely that fund advisers, many of whom already provide/update documents in this manner, would find this method far more cost-effective and efficient.

117. We considered requiring the proposed quarterly statement disclosures to be submitted using a structured, machine-readable data language. Such format may facilitate comparisons of quarterly statement disclosures across advisers and periods. Should we require advisers to provide quarterly statements in a machine-readable data language, such as Inline eXtensible Business Reporting Language ("Inline XBRL")? Why or why not? Would such a requirement make the quarterly statements, and the information included therein, easier for investors to analyze? For example, would it be useful for investors to download quarterly statement information directly into spreadsheets, particularly for institutional investors that may have a significant number of private fund investments? Would a machine-readable data language impose undue additional costs and burdens on advisers? Please provide support for your response, including, where available, cost data.

Our experience is that investors generally do not request reports to be provided to them in Inline XBRL format, and therefore, we believe the costs to advisers associated with instituting such a requirement would significantly outweigh any hypothetical benefit to investors. Based on our manager members' experience with Inline XBRL formatting of government filings, we would expect additional staffing would be needed to check for and correct anticipated errors in the report.

118. Omitted.

119. Do commenters agree that the proposed rule should require advisers to consolidate reporting to cover related funds to the extent doing so would provide more meaningful information to investors and would not be misleading? Alternatively, should we prohibit advisers from consolidating information for multiple funds? Why or why not? Should the rule permit, rather than require, consolidated reporting?

Given that the Commission does not require advisers to consolidate related funds, we generally support the flexibility granted to advisers in the Proposal to use a principles-based approach to consolidate reporting on the basis that related funds are deemed by the adviser to be "substantially similar pools of assets". However, we are concerned that the definition of "substantially similar pools of assets" is broader than how such pools are actually described in the Proposing Release, which may further confuse advisers attempting to make these determinations.[82] We request that the Commission define the term "substantially similar pool of assets" to only include pooled investment vehicles that are designed to invest *pari passu* with each other, as such vehicles are more likely to have a similar risk/return profile to the private fund such that the treatment of investors in those vehicles will be more relevant to the private fund's investors. Furthermore, we would note that while the definition carves out registered investment companies, it does not carve out UCITS, which are similar in nature.

120. Should we require advisers to provide a consolidated quarterly statement for funds that are part of the same strategy, such as parallel funds, feeder funds, and master funds? Alternatively, should these types of funds have separate reporting? For example, should feeder fund investors receive a quarterly statement covering the feeder fund and a separate quarterly statement covering the main fund or master fund? How should the rule address the fact that certain funds may have different expenses (e.g., an offshore fund may have director expenses while an onshore fund may not)? Should we require advisers to provide investors with a summary of any fund-specific expenses and the corresponding dollar amount(s)? Should such a requirement be triggered only if the fund-specific expense exceeds a certain threshold, such as a percentage of the fund size (e.g., .01%, .05%, or .10% of the fund's size) or a specific dollar amount (e.g., $15,000, $30,000, or $50,000)?

No, the Commission should not adopt such a requirement but rather, as proposed, permit advisers the flexibility to determine whether or not consolidated reporting would provide more useful and less confusing information to investors.

121. Omitted.

122. We also recognize that certain private funds have multiple classes (or other groupings such as series or tranches) of interests or shares. The proposed rule would require the quarterly statement to present fund-wide information. Would advisers face challenges in calculating fee, expense, and performance information if there are differences in fees, allocations, and/or expenses between or among classes, series, or tranches? Should we require disclosure of class-specific fees and expenses, or of the differences among classes? Why or why not? Should we instead permit or require quarterly statements for multi-class private funds to present the proposed fee and expense and performance information on a class-by-class basis, particularly if each

[82] A *substantially similar pool of assets* is defined as "a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons." Proposed Rule 211(h)(1)–1.

class (or series or tranche) is considered a distinct private fund or separate legal entity (with segregated assets and liabilities) under applicable law? Would such an approach provide more meaningful information for investors in each of those classes, given the potential for different fee, allocation, and expense structures? Should we require quarterly statements for multiclass (or multi-series or multi-tranche) private funds to present class-by-class (or series-by-series or tranche-by-tranche) information to the extent each class (or series or tranche) holds different investments?

The Commission should, as proposed, only require the provision of fund-level information on the statement.

123. Should advisers only be required to distribute a class' quarterly statement to interest holders of such class, or should all fund investors be entitled to receive such statement regardless of whether they are interest holders of the relevant class if the rule permits or requires class-specific quarterly statements for multi-class private funds?

Given that advisers, to the extent that such information is material to investors, are already required to disclose to all investors any differences in terms, economics, etc. between classes in multi-class private funds, it would be unnecessary to provide each class with the statements for all classes. The costs imposed on advisers to comply with such a requirement would outweigh the benefits to investors, as much of this information will be irrelevant to them. Investors will almost certainly seek to focus their time and resources on understanding information applicable to their investment. To the extent that investors are interested in fees, expenses and performance of other classes, such investors may not be able to switch classes for regulatory, financial or other reasons, and, accordingly, the benefits of having this information are minimal at best.

124. Certain advisers provide combined financial statements covering multiple funds. Should we require or permit advisers to provide consolidated quarterly statements for funds that have combined financial statements? Why or why not?

Yes, combined financial statements should be permitted in order for the presentation of information to be consistent with the audited financial statement requirements.

125. Should the proposed quarterly statement rule include a provision on formatting and content? Why or why not?

The Commission should not adopt prescriptive formatting and content requirements. Furthermore, we believe that, as we suggest in Question 3, the format and content provisions should be based on the requirements for the fund's audited financial statements.

126. Do commenters agree with the flexibility of the proposed format and content requirements, or should we prescribe wording? For example, should we require a cover page with prescribed wording? If so, what prescribed wording should we require?

See our response to Question 125.

127. To meet the rule's formatting requirements, any information that an adviser chooses to include in a quarterly statement, but that is not required by the rule, would be required to be presented in a manner that is no more prominent than the required information. Should the rule, instead, require that advisers more prominently present information that is required by the proposed quarterly statement rule (as opposed to supplemental information that is merely permitted)? If an adviser chooses to include supplemental information, should we require that adviser to disclose what information in the quarterly statement is required versus that which is voluntary?

See our response to Question 125.

128. Omitted.

129. Should we require advisers to retain a record of each addressee, the date(s) the statement was sent, address(es), and delivery method(s) for each quarterly statement, as proposed? Should we instead eliminate this requirement because of the potential burdens?

If this recordkeeping requirement is adopted as proposed, it would impose more substantial and burdensome recordkeeping obligations on advisers with respect to the delivery of statements sent to private fund investors than is required under the Custody Rule with respect to account statements sent to clients that include retail investors. The Commission should instead permit advisers the flexibility to demonstrate compliance with the requirement through other methods (as with the Custody Rule).

130. Omitted.

X. Responses to the Commission's Questions regarding the Mandatory Audit Rule

131. Omitted.

132. The proposed audit rule bears many similarities to provisions of the custody rule; however, one notable difference is that there would be no option to, instead, undergo a surprise examination and rely on a qualified custodian to deliver quarterly statements. What would be the impact on advisers to private funds that are not relying on the custody rule's audit provision? Are private funds undergoing similar audits of their financial statements for other reasons, or would this represent a new requirement for them? There also are no exceptions from the proposed rule, as there are in the custody rule, such as the exception from the surprise examination requirement for advisers whose sole basis for being subject to the rule is because they have authority to deduct their advisory fees. What would be the impact on advisers to private funds that are relying on this and other exceptions? Do many private fund advisers rely on the exception for fee-deduction?

The Mandatory Audit Rule would, in our view, effectively negate the ability of an adviser to rely on the surprise examination provision in the Custody Rule. While it did not do so in the Proposing

Release, the Commission should have considered the impact on advisers, which we believe will be substantial, as part of its cost-benefit analysis.

133. Do commenters agree that the similarities of the audit requirements for the custody rule and for the proposed rule would ease the compliance burdens of advisers that would be required to comply with both? Should the rule provide that compliance with one rule would satisfy the requirements of the other, given the similarities of the two rules? Why or why not?

The Commission concedes in the Proposing Release that the financial statement audit would be identical under both rules but justifies the new requirements on the basis that, unlike the Custody Rule, advisers under the Mandatory Audit Rule would not have the option of obtaining a surprise examination rather than an audit (the latter being the approach preferred by the Commission). In fact, the Commission indicates that the rule would require even those advisers that opt for a surprise examination for Custody Rule purposes to have their private fund client undergo a financial statement audit. This effectively eliminates the surprise examination option under the Custody Rule for private fund advisers without any evidence that surprise examinations have not sufficiently protected investors in funds for which advisers have availed themselves of that option. It also ignores the reality that for those advisers who use it, the surprise examination option is often a function of the limited number of available qualified auditors compared with the number of investment vehicles for which an audit would be necessary.

Accordingly, if the Commission adopts the rule in some form, it should either–

- harmonize the Mandatory Audit Rule with the Custody Rule by, at a minimum, aligning the timing of distribution of the audited financial statements with those under the Custody Rule (120 days after the end of its fiscal year) and removing the requirements that the audit be performed in accordance with U.S. GAAS and by an auditor that meets the independence standards of Regulation S-X (neither of which are mandatory under the Custody Rule); or

- explicitly provide that compliance with one would satisfy the requirements of the other, in order to avoid duplicative and costly audit requirements.

Neither of these two less burdensome options was raised in the Proposing Release or considered as part of the cost-benefit analysis.

Furthermore, the Commission should modify the Proposal to eliminate the requirement of a written agreement between the adviser or the private fund and the auditor pursuant to which the auditor would be required to notify the Commission's Division of Examinations upon the auditor's termination or issuance of a modified opinion. As the Commission notes, this is not a requirement under the Custody Rule, and would impose greater administrative burdens on registered private fund advisers than apply to non-private fund advisers in this context. It is not clear how the Commission's stated justifications (that the requirement would "enable our staff to identify advisers potentially engaged in harmful misconduct and who have other compliance issues"[83])

[83] Proposing Release, *supra* note 3, at 16912.

apply with respect to private fund audits under the Proposal but do not seem to be implicated with respect to audits performed pursuant to the Custody Rule. The Commission should also clarify that the costs associated with the mandatory audit under the Mandatory Audit Rule are not included in the prohibition on charging the fund for adviser regulatory compliance fees and expenses in the Prohibited Activities Rule. This would be in accordance with the current common understanding that the cost of the fund's audit is a fund expense.

134. Omitted.

135. Should the rule apply to all advisers to private funds, rather than to just advisers to private funds that are registered or are required to be registered? Should it apply to exempt reporting advisers? Why or why not?

The Commission should not extend the audit requirement to all advisers. The Custody Rule only applies to advisers to private funds that are registered or are required to be registered, and given the substantial similarities between the two rules, our view is that their application should be identical. As the Commission recognizes, many advisers that would now be subject to the new audit rule already have experience complying with the Custody Rule. The audit rule would impose a far greater burden (including substantial costs) on exempt reporting advisers, who are not required to comply with the Custody Rule. This is exacerbated by the fact that many exempt reporting advisers are based outside of the United States, and thus may have limited access to auditors registered with the Public Company Accounting Oversight Board ("PCAOB"), as is required under the rule. Therefore, funds advised by such advisers may historically have not been audited by a PCAOB-registered auditor. Having an audit performed by a PCAOB-registered auditor, the Commission acknowledges, is more costly, and will be even more so in jurisdictions where such auditors are limited (and can therefore demand higher prices for their services). The Commission reports that more than 90% of funds advised by *registered* advisers currently undergo a financial statement audit, but it was not able to quantify how many of those audits are performed by a PCAOB-registered auditor. The Commission should fully understand the expected burdens on *registered* advisers, at a minimum, before it considers expanding the application of the requirement more broadly.

136. Similarly, should it apply in the context of all pooled investment vehicle clients (e.g., funds that rely on section 3(c)(5) of the Investment Company Act), rather than just in the context of those that meet the Advisers Act definition of private fund? Should it apply more broadly to any advisory account with financial statements that can be audited? Why or why not?

No. The scope should not be broadened, and, in fact, U.S. registered funds (e.g., mutual funds) as well as UCITS and other similar non-U.S. retail funds should be specifically carved out. See also our response to Question 6.

137. Should the rule provide any full or partial exceptions, such as when an adviser plays no role in valuing the fund's assets, receives little or no compensation for its services, or receives no compensation based on the value of the fund's assets? Should the rule provide exceptions for private funds below a certain asset threshold (e.g., less than $5 million)? A higher or lower amount? Should the rule provide exemptions for private

funds that have only related person investors, or that have a limited number of investors, such as 5 or fewer investors? If yes, please identify which advisers or funds we should except, from which aspects of the proposed audit rule, and why.

The Mandatory Audit Rule should exempt funds of one, as many of the proffered policy justifications underlying the rule would not be relevant in a single-investor vehicle, in which the investor is likely to have more favorable and heavily negotiated transparency. The Mandatory Audit Rule should also exempt insider-only funds, sub-advisory mandates, funds in liquidation and funds where the adviser plays no role in the valuation of the assets.

138. Should the rule apply to a sub-adviser to a private fund? In situations where a fund has multiple advisers, is it clear that a single audit of the fund's financial statements may satisfy the proposed audit rule for all of the advisers subject to the rule?

The Commission should clarify that the Mandatory Audit Rule does not apply to advisers with respect to any private fund for which it is acting as a sub-adviser, as a sub-adviser is rarely in a position to compel a fund to undergo an audit and lacks access to the books and records required to prepare financial statements or support an auditor's activities.

While we presume that the language requiring an adviser to cause the fund to undergo an audit only "if the private fund does not otherwise undergo such an audit" is meant to limit the requirement to one audit per fund, it may be worth clarifying that an adviser need not comply with the Mandatory Audit Rule if another adviser in the fund structure has done or will do so.

139. Should the alternative of "taking all reasonable steps" to cause a private fund client to be audited apply in any situation, rather than just in situations where the adviser is not in a control relationship with its fund client? Why or why not? Is it sufficiently clear how an investment adviser can establish that it has "taken all reasonable steps" to cause a private fund client to obtain an audit?

The Commission should only apply the Mandatory Audit Rule with respect to private funds controlled by the adviser. The Commission should further modify the proposed rule to eliminate the "taking all reasonable steps" requirement, as this imposes an unnecessary administrative burden on advisers that would likely be unable in practice to compel the controlling adviser (assuming that such adviser would not be independently required to comply with the Mandatory Audit Rule) to cause the private fund to undergo an audit. The "reasonable steps" requirement also (i) unfairly shifts compliance burdens from one adviser to another (in the case where the controlling adviser is also subject to this rule), and (ii) will limit investor choice since advisers that are unable to compel the controlling adviser to prepare an audit will be unable to accept the advisory mandate.

140. Omitted.

141. Do commenters agree that the availability of accountants to perform services for purposes of the proposed audit rule is sufficient and that even advisers in foreign jurisdictions (or with private fund clients in foreign jurisdictions) would not have significant difficulty in finding a local accountant that is eligible to perform an audit

under the proposed rule? Do advisers have reasonable access to independent public accountants that are registered with, and subject to inspection by, the PCAOB in the foreign jurisdictions in which they operate? If not, how should the rule address this issue?

While we believe that in most jurisdictions, advisers would have access to independent public accountants registered with, and subject to inspection by, the PCAOB, in certain jurisdictions such accountants may have difficulty fully complying with the independence requirements under Sarbanes-Oxley, and there may only be a single auditor able to meet the requisite standards for some funds. This can happen where non-U.S. funds are advised by an adviser in a public company group that requires a Sarbanes-Oxley audit and where various of the other auditors have been engaged for non-audit services by various group companies. For some fund strategies, the independent auditor chosen for the top-level public company would not be one of the local PCAOB auditors with sufficient expertise to perform the fund audits. This would therefore impose substantial burdens on registered non-U.S. advisers.

142. Should the rule require advisers to obtain audits performed under rule 1-02(d) of Regulation S-X, as proposed? If not, what other auditing standards should the rule allow? Are there certain non-U.S. auditing standards that the proposed rule should explicitly include? Should the rule require private funds to prepare audited financial statements in accordance with generally accepted accounting principles, as proposed? Should the rule include any additional requirements regarding the preparation of financial statements? If so, what requirements, and why?

Rule 1-02(d) of Regulation S-X requires U.S. GAAS for all audits, however, registered advisers not subject to the Custody Rule likely would not have ever been previously required to perform a U.S. GAAS audit, which is substantially more costly than an IFRS audit. Although the Proposing Release acknowledges this[84], the cost-benefit analysis does not attempt to quantify the cost difference this implies.

143. Omitted.

144. Omitted.

145. Do commenters agree that the proposed rule's requirement to distribute the audited financial statements promptly would provide appropriate flexibility regarding the timing of the distribution of audited financial statements? Should there nevertheless be an outer limit on the number of days an investment adviser has from its fiscal year end for the distribution of audited financial statements? If so, what should that limit be? Would it be more appropriate for distribution to be required within 120 days of the end of the fund's fiscal year, as under the custody rule? Alternatively, would a longer or shorter period be appropriate in most circumstances? Should the timeline for distributing audited financial statements align with the timeline for distributing quarterly statements under the proposed quarterly statement rule? Why or why not?

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[84] Proposing Release, *supra* note 3, at 16954.

We understand that funds of funds or certain funds in master-feeder structures (including those advised by related persons) have difficulty satisfying the 120-day requirement and that our staff has indicated they would not recommend enforcement if certain of these funds satisfy the distribution requirement within 180 or 260 days of the fund's fiscal year end, depending on a variety of circumstances. If the rule contained a specific distribution deadline, would these types of funds need a separate deadline or other special treatment?

We would urge the Commission, for consistency, to adopt a timing requirement that is the same as is required under the Custody Rule.

146. Omitted.

147. Omitted.

148. Omitted.

149. Advisers would be required to comply with the proposed audit rule beginning with their first fiscal year after the compliance date and any liquidation that occurs after the compliance date. Advisers would also be required to obtain an audit annually. We understand that newly formed and liquidating funds may face unique challenges. For instance, the value provided by an audit of a very short period of time, such as a period of less than three-months (a "stub period"), may be diminished because there is a lack of comparability in the information provided. In addition, we understand that the cost of obtaining an audit covering a few months can be similar to the cost of an audit covering an entire fiscal year. We further understand that when newly formed entities have few financial transactions and/or investments, obtaining an audit, relative to the investor protections ultimately offered by obtaining the audit, may be burdensome. Should the rule allow newly formed or liquidating entities to obtain an audit less frequently than annually to avoid stub period audits? Should the rule permit advisers to satisfy the audit requirement by relying on an audit on an interval other than annually when a fund is liquidating? For example, should we allow advisers to rely on an audit of a fund every two years during the liquidation process?

We would support the ability for newly formed or liquidating entities to obtain an audit less frequently than annually in order to avoid the added expense of a stub period audit. With respect to audits while a fund is liquidating, as the Commission acknowledges in the Proposing Release, during the liquidation process funds may execute few transactions and hold a *de minimis* number of investments, and an annual audit could represent a significant portion of the fund's remaining assets. Investors in a liquidating fund likely would not wish to assume the costs of frequent audits. Accordingly, the Commission should allow advisers to satisfy the audit requirement on an interval less than annually and allow advisers to work with investors to determine the period that best meets the needs of the fund's investors.

150. Omitted.

151. Omitted.

152. Omitted.

153. Omitted.

154. We are not proposing the filing of a copy of the audit report or a copy of the audited financial statements with the Commission; should the rule contain such a requirement? Why or why not?

We do not believe that filing of the audited financial statements should be required, particularly given that the audited financial statements would already be required to be distributed to existing investors, and thus filing would not further protect investors. Furthermore, the Commission has access to this information on inspection and the parts of this information deemed necessary for systemic risk monitoring purposes are already included in the Form PF.

155. Omitted.

156. Should we, as proposed, require advisers to enter into, or cause a private fund to enter into, a written agreement with the independent public accountant completing the audit to notify the Commission in connection with a modified opinion or termination?

See response to Question 133.

157. Omitted.

158. As noted above, the proposed Commission notification provision bears some similarities to, and is drawn from our experience with, a similar custody rule requirement in the surprise examination context with which we believe advisers may likely already have some familiarity. Rule 17a-5 requires a broker or dealer's self-report to the Commission within one business day and to provide a copy to the accountant. The accountant must report to the Commission about any aspects of the broker or dealer's report with which the accountant does not agree. If the broker or dealer fails to self-report, the accountant must report to the Commission to describe any material weaknesses or any instances of non-compliance that triggered the notification requirement. Should the audit rule contain similar requirements? Why or why not? Are private fund advisers and the accountants that perform private fund financial statement audits more familiar with Rule 17a-5's notification requirement than the custody rule's notification requirement?

The Commission should explicitly clarify that notification to the Commission will not be required in connection with the termination of an auditor's engagement when such termination occurs pursuant to a mandatory rotation of auditing firms.

159. Do commenters agree that the related proposed amendments to the books and records rule would facilitate compliance with the proposed audit rule? What additional or alternative amendments should the rule include, if any?

The Commission should consider whether different requirements should apply with respect to audits occurring during the pre-liquidation and liquidation periods.

IX. Responses to the Commission's Questions regarding the Adviser-Led Secondaries Rule

160. Do commenters agree that adviser-led secondary transactions can be of some benefit to a private fund and its investors?

We agree that adviser-led secondary transactions benefit a private fund and its investors. In fact, such transactions are often initiated by *investors* to provide them a mechanism to obtain liquidity. Many investors view secondary transactions as a way to rebalance their portfolios or lock in gains from well-performing private equity investments. As the Commission notes in the Proposing Release, adviser-led secondary transactions often have the goal of securing additional capital and/or time to maximize the value of fund assets, which clearly provides a benefit to both the fund and its investors.

161. Do commenters agree with the scope of the proposed rule? Should the rule apply to all investment advisers? Why or why not? What are the factors that weigh in favor of expanding the scope of the proposed rule to apply to a broader scope of advisers than proposed? Are there particular types of advisers that should or should not be subject to the rule? Should the rule only apply when the adviser or its related person is general partner (or equivalent) of a fund that is party to the transaction?

If the Adviser-Led Secondaries Rule is adopted, it should only apply to registered investment advisers, as proposed, for the reasons cited in Section VI of this Annex.

162. Omitted.

163. Should certain adviser-led transactions be exempt from the rule, such as adviser-led transactions involving liquid funds? For example, if the underlying assets being sold in the transaction are predominantly publicly traded securities, should advisers still be required to obtain a fairness opinion? Do such transactions present the same concerns as adviser-led secondary transactions involving illiquid funds where the underlying assets are typically illiquid and not listed or quoted on a securities exchange? Are there other hedge fund transactions that we should exempt from the rule, such as hedge fund restructurings where an adviser may be merging the portfolios of two different hedge funds and gives all affected investors the option to redeem or convert/exchange their interests into the new fund? Should the exemption depend on whether the price of the transaction is based on net asset value? Why or why not?

If the Commission adopts this requirement, it should explicitly exclude: (i) a transaction involving a fund's redomiciliation or a merger of fund portfolios, if conducted at relative net asset value; and (ii) a transaction conducted based on observable prices. Furthermore, the Commission should provide that an independent third-party valuation would be an acceptable alternative to a fairness opinion.

164. Are there other transactions for which we should require private fund advisers to obtain a fairness opinion? For example, should we require advisers to obtain a fairness opinion before certain cross transactions between private funds it manages? If so, which transactions? Should we provide certain cross transaction exemptions, such as

exemptions for bridge financings or syndications where the selling fund transfers the investments within a short period at a price equal to cost plus interest?

The Commission should not expand this requirement to other transactions, such as cross transactions.

Cross transactions are intended to be beneficial to investors on both sides of the transaction because they avoid the need to pay a commission or spread to a broker-dealer on both sides of the trade, and such a requirement would discourage otherwise beneficial cross transactions by imposing significant costs in time and expense. Furthermore, such an opinion would be unnecessary in connection with transactions involving level 1 and level 2 assets (which are generally easier to value). Moreover, requiring a fairness opinion would ignore other viable alternatives to ensuring fair pricing, such as (but not limited to) an independent agent, auction or, when more cost-effective, a third-party valuation. If the costs imposed by the Adviser-Led Secondaries Rule are too high, advisers will simply sell the assets from one fund into the market and buy them back from the market for the other fund, incurring unnecessary costs on both sides of the transaction.

The requirements of Section 206(3) of the Advisers Act and Rule 206(3)-2 under the Advisers Act (with respect to agency cross trades), the adviser's fiduciary duties under the Advisers Act and, in many cases, the fund disclosures and/or governing agreements already provide investors with ample protection.

165. Should the scope of the fairness opinion be limited to the price, as proposed? Alternatively, should we require the fairness opinion to cover all, or certain other, terms of the transaction? For example, should we revise the definition of "fairness opinion" to a written opinion stating that the terms of the adviser-led secondary transaction are fair to the private fund? Why or why not?

Firms are unlikely to be willing to opine on non-price terms of a transaction. Those firms that would provide such an opinion would undoubtedly charge more to account for the heightened risk of second-guessing by regulators or disappointed parties on either side of the transaction.

166. Should the rule give investment advisers the option to obtain either a fairness opinion or a third-party valuation? Why or why not? What are the advantages and disadvantages of a third-party valuation as compared to a fairness opinion, and vice versa?

As the Commission notes in the Proposing Release, obtaining a third-party valuation would likely be significantly more costly for an adviser to obtain than a fairness opinion, and such added costs may reduce the attractiveness of secondary transactions to investors.[85] We disagree with this conclusion. It is common industry practice for participants to validate the "transfer price" of interests using either fairness opinions, third-party valuations or third-party assurance reviews. Advisers typically use third-party opinions to justify that the transfer price is "reasonable" (the

[85] Proposing Release, *supra* note 3, at 16961.

executed transaction price may differ). However, fairness opinions are generally the most expensive and time consuming of the three options.

We recommend the Commission broaden the range of options for advisers to include independent valuations and assurance reviews. Both offer a similar level of investor protection but at materially lower cost/effort to the adviser (and ultimately investor). This will also ensure the universe of potential service providers for advisers to choose from is wide, allowing them to obtain the most cost-effective solutions that achieve the investor protection the Commission seeks, albeit potentially at a lower cost.

167. Omitted.

168. Omitted.

169. Instead of requiring disclosure of any material business relationships between the adviser (or its related persons) and the independent opinion provider, should the rule prohibit firms with certain business relationships with the adviser, its related persons, or the private fund from providing the fairness opinion? For example, if a firm has provided consulting, prime broker, audit, capital raising, or investment banking services to the private fund or the adviser or its related persons within a certain time period – such as two or three years – should the rule prohibit the firm from providing the opinion? If so, should the rule include a threshold of materiality, regularity, or frequency for some or all of such services to trigger such a prohibition?

We would not recommend that the Commission adopt these prohibitions. Given that a relatively limited number of firms are likely to qualify as “independent opinion providers” as defined in the Proposal, an outright prohibition would drive up costs of obtaining the fairness opinion (which would be borne by the fund) rather than providing advisers the flexibility to seek a fairness opinion at the best price for the fund.

170. Omitted.

171. Omitted.

172. Omitted.

173. Omitted.

174. Omitted.

175. Omitted.

176. Omitted.

177. Omitted.

178. Omitted.

179. Omitted.

180. Omitted.

181. Omitted.

182. Should we require advisers to retain a record of each addressee, the date(s) the statement was sent, address(es), and delivery method(s) as proposed? Why or why not?

The Commission's prescribed recordkeeping and retention requirements in the Proposal go beyond existing requirements under the books and records rule with respect to other adviser activities. Furthermore, this requirement would be particularly burdensome on private fund advisers that advise funds with a significant number of investors.

XI. Responses to the Commission's Questions regarding the Prohibited Activities Rule

General

183. Should the rule apply to all advisers as proposed? Alternatively, should the rule apply only to SEC-registered advisers? If so, why?

We strongly oppose the Prohibited Activities Rule in all respects.

However, if the Commission decides to adopt it either in full or in part, we believe it should only apply to SEC-registered advisers. The Commission has historically distinguished between SEC-registered and exempt advisers with respect to substantive requirements it imposes under the Advisers Act. Advisers that rely on the private fund adviser exemption or foreign private adviser exemption often do so in order to access U.S. investor capital without having to subject themselves to the full Advisers Act regulatory regime. The Commission itself has recognized that U.S. investors may be precluded from opportunities to invest in offshore funds if offshore investors were so regulated, and thus understand that they cannot expect the full protections of the U.S. securities law with respect to their investment in the offshore fund.[86] Extending the Prohibited Activities Rule to those offshore advisers will likely chill their U.S. activities as they weigh the costs and benefits of compliance with these new requirements. Moreover, non-U.S. advisers relying on one of these exemptions may be already subject to substantive regulation in other jurisdictions, creating the potential for conflict with these new requirements. Finally, the number of U.S. investors and amount of U.S. capital in funds managed by foreign private advisers is minimal (as a result of the requirements of the exemption) such that the consequences of the Prohibited Activities Rule would be especially disproportionate in light of the actual investor risk.

184. Omitted.

185. We have 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. In taking this approach, the Commission noted that U.S. investors in an offshore fund generally would not expect the full protection of the U.S.

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[86] Proposing Release, *supra* note 3, at 16921.

securities laws and that U.S. investors may be precluded from an opportunity to invest in an offshore fund if their participation would result in full application of the Advisers Act and rules thereunder. Similarly, the proposed prohibited activities rule would not apply to a registered offshore adviser's private funds organized outside of the United States, regardless of whether the private funds have U.S. investors. Do commenters agree that registered offshore advisers should not be subject to this rule with respect to their offshore private fund clients or offshore investors? Should other rules in this rulemaking package take the same approach, or a different approach, with respect to a registered offshore adviser's offshore private fund clients? Please explain.

The Commission should continue to take its historic approach with respect to all of the proposed rules, as it has, to date, successfully facilitated the expansion of investment opportunities for U.S. investors and access to U.S. capital for registered offshore advisers. Registered offshore advisers newly subject to substantive prohibitions and requirements of the Advisers Act with respect to their offshore funds may weigh these additional costs and determine that it is no longer desirable to offer these products to U.S. investors or might compel existing U.S. investors to redeem their interests, to the extent permitted under the fund documents. This could result in fewer new fund products being offered in the United States and therefore reduce competition and investor choice.

Furthermore, for the avoidance of doubt, the Commission should clarify that the proposed rules will also not apply with respect to the offshore private fund clients of an *unregistered* offshore adviser. A different application would have the illogical result of imposing more onerous requirements on unregistered offshore advisers than on registered offshore advisers, despite the fact that the historical justifications for excluding offshore clients of registered advisers apply equally with respect to offshore clients of unregistered advisers.

186. Instead of prohibiting these activities, should the rule prohibit these activities unless the adviser 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)? Should the rule prohibit these activities unless the adviser obtains approval for them by a majority (by number and/or in interest) of investors? Should the rule permit non pro-rata fee and expense allocations if such practice is disclosed to, and consented by, co-investors?

The Commission has, historically, taken a less prescriptive approach with respect to private funds and private fund investors than registered funds and retail investors, and has instead relied on a model of disclosure and implied consent. Private fund advisers and investors understand that consent to terms that are clearly and accurately disclosed is implicit in the decision to invest or remain invested in the fund. This not only includes consent to terms that would be prohibited under the Proposal, but also to the governance mechanism outlined in the fund documents.

By imposing outright prohibitions on these activities, the Commission suggests that such activities are *per se* harmful to investors, even though the Commission has never previously taken such a position with respect to these long-standing practices, nor has it presented sufficient support in the Proposing Release for treating them in such a manner. We are concerned that the Commission's new approach to these activities unintentionally subjects advisers and funds to potential litigation arising from practices that both the Commission and fund investors had full knowledge of and endorsed. Moreover, as we discuss elsewhere, prohibiting these activities would have a myriad of unintended and adverse consequences on investors, including increased costs and the elimination or discouragement of various fund terms and practices that benefit investors.

While we believe that the optimal outcome from the perspective of both advisers and investors is to continue to permit the approach of disclosure and implied consent to the proposed prohibited activities, we believe that disclosure to and more explicit consent—whether by the relevant governing body (e.g., an investor advisory committee or independent representative) on behalf of all investors or by investors individually (e.g., in connection with their initial subscription for interests in a private fund) or collectively (e.g., through an investor consent obtained in the manner prescribed by, and subject to the terms of, a private funds' governing documents)—to be significantly better (and more in line with the best interests of investors) than an outright ban on such activities. For the avoidance of doubt, we believe this to be the case with respect to both the Prohibited Activities Rule and the Preferential Treatment Rule, which also include various prohibitions and other prescriptive requirements that would be better handled through *ex ante* disclosure and express consent.

Such a disclosure and express consent model would eliminate any residual confusion regarding what is or is not permissible (although we believe such confusion to be minimal to begin with) and would allow the sophisticated investors that invest in private funds to make their own choices and assessments regarding the potential benefits and costs of investing in any particular private fund.

187. Should we amend the books and records rule to require advisers to retain specific documentation evidencing compliance with the prohibited activities rule? For example, records showing how fees and expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities were paid or showing the allocations of fees and expenses related to a portfolio investment on an investment by investment basis? Would advisers be able to obtain or generate sufficient records to demonstrate compliance with all aspects of the proposed rule? Should we amend the books and records rule to require advisers to prepare a memorandum on an annual basis attesting to their compliance with each aspect of the proposed rule?

No, the Commission should not amend the books and records rule, as proposed in this question, as such requirements are likely to be highly operationally burdensome with minimal, if any, investor benefit.

Fees for Unperformed Services

188. Are there any scenarios in which we should permit an adviser to charge a fund's portfolio investment for unperformed services? If so, please explain.

We are concerned that, as proposed, the rule could capture an arrangement where, although the adviser can charge a fund's portfolio investment, the fund is the recipient of the proceeds. In the case of lending funds, for example, we believe there are fees such as early termination and loan-call fees that offset lost servicing income and benefit the fund itself. Accordingly, the Commission should consider permitting such charges where the adviser has a reasonable belief that they would provide a material benefit to the private fund.

189. Should we prohibit an adviser from being paid in advance for services it reasonably expects to provide in the future? Why or why not?

No, the Commission should not adopt such a prohibition if such payments are disclosed to investors.

190. Omitted.

191. Omitted.

192. Omitted.

193. Should the rule instead permit an adviser to engage in this activity if the adviser satisfies certain disclosure, governance, and/or other conditions (e.g., disclosure to investors in all relevant funds/vehicles, approval by the LPAC (or other similar body) or directors)?

We believe that disclosure to investors that the adviser may receive such fees (and a description of related conflicts) would be sufficient to address the Commission's concerns. We would note that the 2015 enforcement action cited by the Commission in support of the Proposal related to violations of the Advisers Act due to "the *undisclosed* receipt of fees or conflicts of interest," not due to the fact that such fees were received in the first place.[87]

194. Omitted.

Certain Fees and Expenses

195. Are there circumstances in which it would be appropriate in the public interest or for the protection of investors for a private fund to bear (i) regulatory or compliance expenses of the adviser or its related persons or (ii) expenses related to an examination or investigation of the adviser or its related persons? If so, please explain. Should we permit private funds to bear these fees and expenses if fully disclosed and consented to by the private fund investors and/or an LPAC (despite the limitations of private fund governance mechanisms, as discussed above)? Should we place any conditions on charging these fees and expenses, such as caps, management fee offsets, or detailed reporting requirements in the proposed quarterly statement?

We believe it would be appropriate, in the public interest or for the protection of investors for a private fund to bear (i) regulatory or compliance expenses of the adviser or its related persons or (ii) expenses related to an examination or investigation of the adviser or its related persons *as long*

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[87] *See In re Blackstone Management Partners L.L.C., et al.,* SEC Rel. No. IA-4219 (Oct. 7, 2015), at 6.

as these expenses are fully disclosed. This has the benefit of aligning the interests of investors and advisers and provides greater transparency.

With respect to pass-through funds, it is appropriate and consistent with the protection of investors for these costs of the adviser to be passed through to the fund on a fully disclosed basis, as this reflects the commercial arrangement negotiated with sophisticated investors. Furthermore, investors in open-end funds have the ability to redeem to the extent they are unsatisfied with how these expenses are allocated to the fund. Notably, the Commission does not cite any example of misconduct relating to advisers passing through regulatory, compliance, examination or investigation-related expenses that would justify this prohibition.

With respect to regulatory and compliance costs for investment strategies with a regulatory component, sometimes the regulations apply to the adviser and sometimes to the fund (and sometimes for both as is the case, e.g., for reinsurance). With respect to exams and investigations, these costs are just outright prohibited under the Proposal, even when they relate to the fund/investments and not just to the adviser (unlike regulatory and compliance costs, which are permitted in the case of the former).

In a situation where a fund's investment strategy necessitates that the adviser complies with certain regulatory requirements (e.g., if one of its advised funds employs a direct lending strategy and it is required to register as a lender in one or more states), we would also expect that such compliance costs, including the costs of any related examinations and investigations, be borne by the fund (whether the regulatory regime applies to a fund entity, the adviser or both). If advisers were forced to bear such expenses, it could disincentivize them from pursuing investment strategies involving regulated activities.

As a general matter, we believe that the Commission has relied on flawed assumptions regarding adviser practices in relation to these expenses as the basis for adopting this prohibition. The Commission claims that "[w]e have seen an increase in private fund advisers charging these expenses to private fund clients" but states two paragraphs later that it "do[es] not anticipate this aspect of the proposed prohibited activities rule would cause a dramatic change in practice for most private fund advisers."[88] The Commission appears to only be concerned with the manner in which these expenses are reimbursed, and, in fact, notes that advisers may impose (or increase) a management fee in order to cover them. There is no obvious reason why the Commission's approach is preferable from the perspective of investors, as it would likely result in higher costs, reducing overall returns to investors.

More generally, the Commission acknowledges that "it may not be clear whether certain fees and expenses relate to the fund or the adviser, or it may not be clear until after a significant amount of time has passed in certain cases,"[89] which implies that it recognizes that there may be circumstances in which private funds may appropriately bear regulatory, compliance and/or examination/investigation expenses of the adviser or its related persons if such expenses could arguably also be characterized as fund expenses. This lack of clarity is exemplified in the Proposal

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88 Proposing Release, *supra* note 3, at 16922.

89 *Id*. at 16923.

itself with respect to the audit requirement, for which the Commission notes that it expects "[i]n some instances, the fund will bear the audit expense, in others the adviser will bear it, and there also may be arrangements in which both the adviser and fund will share the expense."[90]

Investigations end relatively frequently with no finding of wrongdoing (e.g., because the adviser did not do anything wrong or because the investigation did not really relate to the adviser at all), but sometimes exams end up with an enforcement action. Accordingly, rather than distinguishing between investigations and exams, we think the real test here should be whether the adviser violated the applicable standard of care in its documents. In the case of a settlement, the Commission can condition its participation on the fund adviser not passing through related costs to the fund. In the case of an unsettled enforcement action, there will be an ultimate finding vis-à-vis the standard of care.

Finally, we believe that the prohibition on charging the private fund for regulatory or compliance fees or expenses of the adviser or its related persons could have meaningful impacts on the compliance practices of private fund advisers. Specifically, we are concerned that some advisers may respond by reducing their compliance expenses, which would increase risk both for such advisers' investors and for the market more generally.

196. The proposed rule would likely increase operating costs for advisers that have historically charged private funds for the types of fees and expenses covered by the proposed rules. Do commenters believe that advisers would increase management fees to offset such increase in operating costs?

While it is impossible to predict how each adviser will respond, many advisers will likely seek to offset these increased operating costs in other ways, including, but not limited to, increasing management fees, or, if the fund did not previously assess a management fee, to begin to do so. In the latter case, a management fee would result in less transparency for investors as to actual fees and expenses that were previously passed through to the fund while eliminating all of the purported benefits asserted by the Commission. In light of the Commission's focus on how these expenses are reimbursed, we would query why permitting the same expenses to be reimbursed through a management fee, but not through a fully disclosed pass-through arrangement where investors are made aware of the actual costs incurred, is a sensible policy outcome. Increasing overall costs to investors while reducing transparency and needlessly and perversely disincentivizing advisers from devoting adequate resources to regulatory compliance as well as from pursuing certain investment strategies cannot be what the Commission intends with this rule.

Furthermore, the increased operating costs will almost certainly have a disproportionate effect on smaller and emerging advisers, who may feel more pressure to recoup the costs through other means, perhaps resulting in the movement of investors away from their funds and towards those managed by larger advisers better able to absorb the new costs (and who may therefore be less

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90 *Id*. at 16954.

compelled to raise fees). Those advisers may also be incentivized to cut down on compliance costs rather than risk the consequences of increasing management or other fees.

197. Omitted.

198. Should we provide exceptions to the proposed rules for certain types of private funds and/or certain types of advisers? For example, should we permit a first-time fund adviser to charge regulatory and compliance expenses to the fund? If so, why? Do commenters agree that many advisers do not currently charge private funds for the types of fees and expenses covered by the proposed rules and, as a result, the proposed rules would not cause a dramatic change in industry practice? Why or why not? To the extent commenters disagree, please provide supporting data.

We disagree with the Commission's claim that many advisers do not currently charge funds for the types of fees and expenses covered by the proposed rule. However, as the Commission did not sufficiently account for current practices in this area, it developed these prohibitions without being able to evaluate and measure their overall effect on private fund advisers.

This prohibition would represent a particularly disruptive change for pass-through funds, which allocate to the funds the actual operating expenses associated with acting as an adviser (including regulatory and compliance expenses) rather than seeking to support those expenses through management fee revenue. As a result of being prohibited from passing on certain types of expenses to investors, advisers utilizing such a model would be compelled to consider restructuring the longstanding fee arrangements that have typically served their investors well.

For the reasons outlined herein, we urge the Commission to withdraw the fee and expense prohibitions under the rule in their entirety.

199. Will advisers have difficulty in determining whether fees and expenses relate to the adviser's activities versus the fund's activities? Should we provide guidance to assist advisers in making such a determination? If so, what guidance should we provide? Should the rule list certain types of fees and expenses that relate to the adviser's activities versus the fund's activities?

If the Commission does not withdraw this proposed rule in its entirety (as we would urge it to do), we would request that the Commission permit a principles-based approach which would allow advisers to determine the appropriate characterization of fees and expenses (and make proper disclosure to investors).

In addition, we would further recommend that the Commission explicitly clarify that expenses associated with the statements required under the Quarterly Statement Rule, the audits required under the Mandatory Audit Rule, the fairness opinions under the Adviser-Led Secondaries Rule, the notification obligations under the Preferential Treatment Rule and books and records rule, and any costs incurred by advisers in connection with their initial compliance with the Proposal more generally (e.g., the costs of amending fund documentation and agreements with investors) could be appropriately treated as fund expenses, rather than adviser expenses. Furthermore, the Commission should clarify that fees or expenses associated with governmental or regulatory authority examinations or investigations that relate to the private fund's investment strategy may be charged to the fund without violating the prohibition.

Finally, the Commission must provide a full exception for advisers utilizing a pass-through expense model.

As a general matter, we would note that, particularly in non-U.S. jurisdictions, advisers may have difficulty assessing what would be considered an adviser as opposed to a fund activity, as indicated by the examples above. In certain jurisdictions, for example, certain fund investments trigger regulatory requirements at the adviser level (e.g., EU short selling reports). Advisers mainly accustomed to AIFMD, for example, will have mostly had experience complying with a regime built around adviser, rather than fund, compliance for fund-related functions.

200. As discussed above, we recognize that certain private fund advisers utilize a pass-through expense model. Should the rule provide any full or partial exceptions for advisers utilizing such models, particularly where the adviser does not charge any management, advisory, or similar fees to the private fund?

The Commission should withdraw the rule related to fees and expenses in its entirety. However, if it is unwilling to do so, the Commission should provide a full exception for advisers utilizing a pass-through expense model, which advisers often use to align their interests with fund investors, given the severe consequences to those advisers and funds (and fund investors). The Proposing Release itself raises a number of issues related to the need for such advisers, as the Commission notes, to re-structure their fee and expense model to comply with the prohibition. While the Commission does not provide an estimate of the costs of such a re-structuring, it acknowledges that they are likely to be substantial enough such that the adviser may not be able to fully compensate for the new costs without negotiating a higher management fee with investors. Advisers utilizing a pass-through expense model may not currently charge management fees, and therefore would need to negotiate an entirely *new* fee with their investors in order to recoup the new costs. Failure to reach an agreement with investors could result in a need to close the fund, limiting competition and investor choice.

The Commission further admits that the prohibitions may limit the adviser's efficiency or effectiveness in providing services that can no longer be passed through to the fund, which could result in lower returns for fund investors or increased compliance risk.[91] For example, the prohibition on charging the private fund for regulatory or compliance fees or expenses of the adviser or its related persons is likely to have meaningful impacts on the compliance practices of private fund advisers, who will have great difficulty estimating the full costs of an effective compliance regime that they will now have to absorb in full.

Moreover, the Commission concedes that hedge fund investors may see lower returns to the extent that re-structuring the expense model diverts resources from the fund's investment

[91] *Id.* at 16949.

strategy, and that the burden would be on the *investor* to mitigate the cost of lower returns through searching for and identifying substitute funds (which itself imposes additional costs).[92]

Reducing Adviser Clawbacks for Taxes

201. Would this aspect of the proposed prohibited activities rule have our intended effect of ensuring that investors receive their full share of profits generated by the fund? Is there an alternative approach that would better produce this intended effect? For example, should we require advisers to return the entire amount of any adviser clawback, rather than only prohibiting advisers from reducing the clawback amount by actual, potential, or hypothetical taxes? Would this approach ensure that investors receive their full share of fund profits?

As a general matter, we believe that the proposed clawback provision could have the result of causing certain investment advisers not to agree to a clawback provision in the first place.

202. Would the proposed clawback provision result in more whole-fund waterfalls (commonly referred to as European waterfalls in the private funds industry), which generally delay payments of performance-based compensation until investors receive a return of all capital contributions? What other effects would this aspect of the proposed rule have on the industry, including with respect to adviser's ability to attract, retain, and develop investment professionals?

We believe that the overall effect of this proposed provision will be to reduce investor choice. For example, some advisers pursue similar investment strategies in both open-end and closed-end funds in order to appeal to differing investor preferences. However, if American-style waterfalls are prohibited, advisers whose expense structures (including employee compensation) do not allow them to wait multiple years to get paid (as would be the case under a European-style waterfall) may simply revert back to offering only open-end funds (which provide annual performance fees without any clawback). Even funds with European waterfalls face investor demands for clawbacks, so a move from the American style to the European style would not necessarily relieve the problem.

203. Instead of the proposed clawback provision, should we prohibit deal-by-deal waterfall arrangements (commonly referred to as American waterfalls)?

The Commission should not prohibit such arrangements, as any prohibition on deal-by-deal waterfall arrangements would be particularly harmful to new advisers. Such advisers are often reliant on these types of arrangements in order to compensate personnel earlier in the life of the fund. We believe that this would have a disproportionate impact on minority- and women-owned advisers.

204. We recognize that clawback mechanisms are more common for closed-end funds and less common for open-end funds. Should the rule separately address performance-

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92 *Id*.

based compensation for open-end private funds? If so, how should we address those funds?

We do not believe that the Commission should put forth any prescriptive requirements regarding performance-based compensation for open-end private funds. The "high-water mark" and other mechanism currently used in such funds to align adviser and investor incentives are a material benefit to investors, and changes to the status quo are likely to fundamentally alter the current compensation models for such funds and to have significant adverse and unintended consequences for investors.

205. Omitted.

206. Omitted.

207. What issues may advisers face in complying with this aspect of the proposed prohibited activities rule? In particular, what issues may result with respect to amending tax returns from prior years?

We would expect that there would be substantial costs to advisers associated with amending prior tax returns that are disproportional to the benefit to investors, given that such investors agreed to these terms at the time they invested into the fund.

208. We recognize that this aspect of the proposed rule might result in delayed payments of performance-based compensation. For example, during the early stages of the fund, the adviser may be less inclined to distribute performance-based compensation to investment professionals that source or manage successful investments. How would this aspect of the proposed prohibited activities rule affect the intended incentive effects of performance-based compensation?

One foreseeable result of delayed payments of performance-based compensation is greater employee turnover. We note that it is common for investors to look at employee turnover as a negative factor when evaluating funds and advisers, and, in an increasingly competitive labor market, talented investment professionals are highly mobile. Imposing rules on advisers that make them even more vulnerable to competition for talent would not help investors, particularly closed-end fund investors who may be required to remain in the fund for several years, and advisers would therefore disproportionately experience the effects of employee turnover.

209. We recognize that many fund agreements clawback performance-based compensation on a post-tax basis. We considered, but are not proposing, a rule that would generally allow this practice to continue, but would prohibit advisers from using a hypothetical marginal tax rate to determine the tax reduction amount. We considered requiring advisers to use the actual marginal tax rates applicable to the adviser or its owners, rather than a hypothetical marginal tax rate. Our view is that this approach could be too burdensome for advisers. Do commenters agree? If we were to adopt this approach, how should we factor tax benefits realized by the adviser or its owners into the tax reduction amount? What operational challenges would advisers face under this alternative approach? For example, would the amount of time

it may take to determine the actual tax amount, which may not be determined until a significant amount of time has passed not justify the benefits? Do commenters believe that the use of a hypothetical marginal tax rate is a reasonable and cost-effective method for determining the tax reduction amount, or do commenters believe that the hypothetical marginal tax rate is too high? Why or why not? Please provide data.

We would note that advisers generally employ the use of hypothetical rates to address the challenges associated with using actual tax rates, including, as the Commission notes, the fact that a significant amount of time passes before the actual rates can be determined. Furthermore, as most fund general partners are flow-through entities for tax purposes, a complicated ownership structure (such as where a fund has bought a minority stake in a general partner) would make figuring out the actual rates paid by each owner an extremely difficult, time-consuming process. We do not view a hypothetical marginal tax rate as "too high" given that it is a number agreed upon by advisers and investors based on known rates (which can vary by jurisdiction) and certain assumptions made by the parties.

Limiting or Eliminating Liability for Adviser Misconduct

210. We have observed these types of contractual provisions among private fund advisers and their related persons; do advisers to clients other than private funds typically include these types of contractual provisions?

Contractual provisions addressing liability standards are common in advisory agreements for separately managed accounts and registered investment companies, among other types of clients, as they are in commercial contracts generally. Such provisions are also commonly included in other service providers' agreements with private funds (such as auditors, administrators, fund directors and data licensors).

211. Are there other types of contractual provisions we should prohibit as contrary to the public interest and the protection of investors?

Our view is that prohibiting contractual provisions agreed between sophisticated parties exceeds the Commission's statutory authority, as we discuss further in Section III of this Annex, and is not in the best interest of investors.

212. Should this aspect of the final prohibited activities rule prohibit limiting liability for "gross negligence," or would prohibiting limitations of liability for ordinary negligence, as proposed, be more appropriate? Why?

For the reasons discussed in Section V of this Annex, we strongly believe that the Commission should withdraw the entirety of proposed Rule 211(h)(2)-1(a)(5), including the proposed prohibition on limitations of liability.

213. Should the proposed rule prohibit contractual provisions that limit or purport to waive fiduciary duties and other liabilities in situations where state law permits such waivers?

No. Private fund investors, as sophisticated parties, understand that an adviser may seek to limit liability for breach of fiduciary duty to the extent permitted under applicable law, in order to take such risks as are both disclosed to investors and necessary and appropriate for the adviser's investment strategy to generate greater returns. Both parties, the adviser and investors, receive the benefit of the bargain when these types of contractual provisions are negotiated, rather than imposed by regulation. Private fund documentation often describes the contours of the adviser's fiduciary obligations. With respect to the duty of loyalty, for example, conflicts of interest are typically disclosed to investors, who then provide their consent to such conflicts, including, for example, that the adviser is managing other funds or accounts. Moreover, in expressing concern that "investors with less bargaining power are forced to bear the brunt of such arrangements,"[93] the Commission ignores two fundamental facts. First, it ignores that such investors also receive the benefits of such arrangements in the form of higher returns and the ability to access innovative investment strategies as part of an overall commercial relationship. Second, it incorrectly assumes that any individualized terms agreed to with larger investors vis-à-vis fiduciary duty and/or an adviser's standard of care will somehow shift burdens on to investors that do not negotiate such terms (i.e., that the investors with less bargaining power will somehow "bear the brunt" of such terms). This is simply not true; just because an adviser has agreed to a higher standard of care or less generous indemnification terms with one investor does not mean that any costs will be (or even can be) shifted to other investors. Instead, we would generally expect that such costs would be borne by the adviser itself.

The Commission also appears to be disregarding its own position in its 2019 Commission Interpretation Regarding the Standard of Conduct for Investment Advisers.[94] The Standard of Conduct Interpretation acknowledged that state law obligations may differ from those enforced by the Commission and that it was not "tak[ing] a position on the scope or substantive of any fiduciary duty that applies to an adviser under applicable state law."[95] Furthermore, with respect to the use of hedge clauses, the Standard of Conduct Interpretation expressed the Commission's view that such clauses in an agreement with a *retail* client would generally violate the antifraud provisions of the Advisers Act. By contrast, whether such clauses in an agreement with an institutional client would violate the antifraud provisions of the Advisers Act "will be determined based on the particular facts and circumstances."[96] The Proposal collapses this distinction and effectively subjects advisers to private funds to more onerous requirements than those applicable with respect to registered investment companies. Notably, it does so with no explanation as to why upending the longstanding distinction between retail and sophisticated private fund investors is reasonable.

Regardless of whether certain fiduciary duties and other liabilities under state law are waived, an adviser's duties under Federal law are non-waivable, as reaffirmed in the Standard of Conduct

93 Proposing Release, *supra* note 3, at 16925.

94 SEC, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 FR 33669 (July 12, 2019) (the "Standard of Conduct Interpretation"). The Commission explicitly recognized that the "application of the fiduciary duty of an adviser to a retail client would be different from the specific application of the fiduciary duty of an adviser to a registered investment company or private fund." Id. at 33679.

95 *Id*. at 33672.

96 *Id*.

Interpretation.[97] Private fund investors understand that advisers cannot waive compliance with the Advisers Act or Federal antifraud provisions. The Commission has not offered any evidence that allowing advisers to waive duties or standards under Cayman Islands law, or under Delaware or other state law (where permitted), has resulted in changes to adviser behavior that have negatively impacted investors. In fact, precisely because advisers' duties under Federal law are non-waivable, advisers will act in accordance with such duties given the likelihood of an enforcement action by the Commission if they fail to do so. Furthermore, it is not clear why the Commission believes that states and other jurisdictions that permit these contractual terms have not appropriately considered whether such terms are consistent with the protection of investors, as the Commission seems to imply in the Proposing Release.

By limiting their liability to the extent permitted by law, advisers reasonably seek to limit litigation risk. The new prohibitions are likely to result in a greater number of fund investors pursuing or threatening to pursue litigation, including in cases where such lawsuits are based on frivolous, unmerited claims. This will divert valuable time and resources of the adviser towards defending against such claims, to the detriment of other investors in the fund. Additionally, as noted in the discussion of the prior question above, private fund advisers may shy away from accepting certain types of investors that they perceive as looking for litigation opportunities or otherwise as posing a heightened litigation risk under the new requirements.

Particularly in light of the substantial impacts described above, the Commission neglected to sufficiently consider potential viable alternatives to the proposed prohibition.

Accordingly, we strongly urge the Commission to withdraw this proposed rule.

214. Do commenters believe that the proposed rule would increase operating expenses for advisers? For example, would the proposed prohibition on receiving indemnification/exculpation for negligence cause an adviser's insurance premium to increase?

Given the breadth of the prohibition and the dramatic effect that it is likely to have on the day-to-day business of private fund advisers, it is highly likely that costs would significantly increase. While it is difficult to estimate the magnitude of the increase (which we believe the Commission should have more thoroughly considered as well), we can assume that the increased cost for insurance coverage, particularly errors and omissions policies, will be substantial. We would also expect a substantial increase in litigation, settlement and other similar costs.

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97 *Id.* ("While the application of the investment adviser's fiduciary duty will vary with the scope of the relationship, the relationship in all cases remains that of a fiduciary to the client. In other words, an adviser's federal fiduciary duty may not be waived, though it will apply in a manner that reflects the agreed-upon scope of the relationship. A contract provision purporting to waive the adviser's federal fiduciary duty generally, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act, would be inconsistent with the Advisers Act, regardless of the sophistication of the client.").

Certain Non-Pro Rata Fee and Expense Allocations

215. Should we prohibit non-pro rata fee and expense allocations as proposed? If not, under what circumstances would non-pro rata allocations be appropriate? For example, we recognize that advisers often have policies and procedures in place that permit the adviser to allocate fees and expenses in a fair and equitable manner (or similar standard), rather than on a pro rata basis; would this better achieve our policy goals? Why or why not? What specific protections are included in such policies and procedures? Should such protections be included in the rule? Why or why not? 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?

The Prohibited Activities Rule would prohibit an adviser from charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis, but it is not clear what it means for a fee or expense to be "related to" an investment or what pro rata means in the context of this requirement.

In some broad sense, every expense that a fund incurs is "related to" investments insofar as the expense is a prerequisite to the fund performing its primary investing function. Of course, in reality some things will be reasonably far removed from investments (e.g., the costs of a third-party administrator) or be clearly related to specific deals (e.g., outside due diligence counsel on a particular investment), but other lines will be much more difficult to draw (e.g., data feeds, software, hardware, etc.). Because the rule is unclear on what "related to" means, it will be very difficult for advisers to draw meaningful lines, which is unfair given the enforcement risk.

It is also unclear what pro rata actually means in this context. We could assume, given the SEC's discussion, that it is meant to be based on the amount invested in a particular deal, but it could also mean pro rata based on other metrics (e.g., AUM, NAV, profit and loss, gross position size, headcount, value contribution) and sometimes one approach is fairer/more equitable than another. Advisers should therefore not be forced into a one-size-fits-all regime that provides bright-line rules but can lead to unfair outcomes for investors. Furthermore, while pro rata allocations (as used in the Proposing Release) may be preferable in relation to certain fees and expenses, for others, requiring such an allocation would cause inefficiencies and could result in inequitable allocations and disincentives to incurring costs that would otherwise benefit funds and their investors.

The Proposal's discussion of examples regarding non-pro rata allocation of fees and expenses indicates that the Commission has not fully considered the full range of how and why advisers allocate expenses. For example, consider the allocation of costs associated with services and equipment (such as a data feed) whose usage may significantly benefit one vehicle but only provide marginal benefits to another, notwithstanding that both vehicles have some degree of overlap in their portfolios. If the relevant adviser is required to allocate costs associated with the data feed on a pro rata basis, investors in the latter vehicle are effectively subsidizing the investors in the former (who are receiving the greater benefit of the data feed). Furthermore, in absolute terms, the latter vehicle's investors would be "overpaying" for the data feed, which could create a strong incentive (and potentially a duty) for the adviser to no longer use it to gather information in connection with trades made by that vehicle. We do not believe that the Commission would intend for such a result. The Commission should permit such allocations (e.g., allocation by usage, value contribution, profitability to the fund and/or overall capital), as long as such methods are fair and equitable to all clients, in circumstances where such allocations more appropriately reflect the actual benefits that investors receive.

Additionally, we would note that it would be impractical to require advisers to allocate certain expenses in a pro rata manner, such as for quantitative or other hedge funds that make thousands of trades per day across multiple vehicles.

Given that pro rata fee and expense allocations are not the optimal approach in certain circumstances, we would recommend that the Commission permit advisers to make investment-related expense allocations in a "fair and equitable" manner. This would provide advisers with the necessary flexibility to allocate fees and expenses most efficiently while also providing investors the protections sought by the Commission.

216. Should the proposed rule apply to unconsummated – or potential – portfolio investments, as proposed? Do commenters agree that non-pro rata allocations of fees and expenses attributable to such investments present the same concerns as the ones discussed above with respect to consummated investments? Why or why not?

In the context of hedge funds, the market has long accepted non-pro rata trade allocations for odd lots and incomplete order fills. The Proposal could have the effect of requiring associated expenses to be allocated on a pro rata basis even where the trade allocation itself was not.

217. We recognize that many co-investors do not agree to bear their pro rata share of broken or dead deal expenses. Would the proposed rule make it difficult for funds to consummate larger investments where co-investment capital is needed? Would the proposed rule cause funds to syndicate more deals post-closing once the adviser is confident that the deal will not fall through?

Typically, co-investors are not pre-committed to any particular portion of a specific co-investment opportunity, will do their own due diligence and then make a commitment to invest (or pass on the investment) near the closing date. Therefore, if a deal is abandoned, it is not clear which investors would appropriately bear expenses incurred in connection with that deal and in what proportions. If the Commission were to mandate that these investors share in deal expenses, the only practical way for advisers to proceed would be to require investors to agree to bear a specific portion of deal expenses as a condition to giving them access to due diligence information. The likely outcome is that investors would proceed with diligence on far fewer co-investment opportunities. This is clearly an undesirable outcome for the many investors who wish to have access to co-investment opportunities, as well as investors in the funds that will have to forego investment opportunities that are large enough to generate co-investment capacity. It would also provide a meaningful advantage to larger funds (who may not need co-investors to proceed with an investment opportunity), as they would face less competition for large-scale investment opportunities.

218. Omitted.

219. Should we define "pro rata"? Should "pro rata" be determined based on each client's ownership (or anticipated ownership) of the portfolio investment? Will advisers interpret "pro rata" differently?

As we have discussed in our response to Question 215, it would be difficult to properly define "pro rata" and, therefore, the Commission should instead require allocations to be made in a "fair and equitable" manner. This could include, among other things, a determination based on each client's actual or expected ownership of the portfolio investment.

220. 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. Should the proposed rule address fees and expense allocations among funds that invest at different times, and if so, how? If a significant amount of time has passed between the first fund's investment and the later fund's investment, should the later fund pay interest on its portion of fees and expenses? Should interest payments always apply when portfolio investments are made at different times? If not, how much time should lapse before interest applies?

No, the Commission should not impose these requirements, which would add unworkable complexity to a myriad of situations. We would further note that the issues raised in these questions appear to be more focused on private equity investments, and therefore may not be applicable or appropriate in, for example, the hedge fund context.

221. Omitted.

222. Omitted.

223. As noted above, the proposed rule would not prohibit an adviser from charging different fund-level compensation, such as advisory fees, to vehicles that invest alongside each other in the same underlying portfolio investment. For example, a co-investment vehicle may pay lower management fees than the main fund. Is it sufficiently clear that such arrangements would not be prohibited under the proposed rule?

While we do not believe that such arrangements would be prohibited under the proposed rule, it would be helpful for the Commission to confirm this understanding.

Borrowing

224. Should we broaden the scope of the prohibition on borrowings to prevent a private fund adviser from borrowing from co-investment vehicles or other accounts that are not private funds?

No, we do not believe the scope should be broadened, as we are already concerned that this prohibition may be overbroad, and is, at the very least, ambiguous. Specifically, prohibiting advisers from "indirectly" borrowing from a private fund could impair the ability of advisers to manage their funds efficiently, absent further clarification from the Commission as to what activities would be captured under the prohibition.

Finally, broadening the restriction could also have the unintended consequence of negatively affecting the viability of downstream investment structures owned by the private fund.

225. Should we broaden the proposed prohibition to apply when an adviser lends to the fund?

No, the Commission should permit advisers to lend to the private fund, both generally but especially in times of financial stress. Advisers should also be able to enter into arrangements in which they advance expenses on behalf of one or more private funds and then recover those expenses, or act as a paymaster on behalf of multiple funds that share the cost of particular expenses. These arrangements are ultimately beneficial to investors.

226. Should the proposed rule exclude certain activity from the prohibition (e.g., scenarios where a private fund makes tax advances or tax distributions to its general partner (or similar control person) to ensure that the general partner and its investment professionals are able to pay their personal taxes derived from the general partner's interest in the fund)? If so, what activity should we exclude and why?

The Commission should clarify that advisers may take tax and other advances against their share of the fund's assets (such as accrued performance fees and deferred compensation balances invested for the benefit or on behalf of the advisers' employees) provided that such arrangements have been fully disclosed in advance. Prohibiting this will have a disproportionately adverse impact for smaller managers, including minority- and women-owned businesses. Such advances benefit investors by, for example, preventing premature asset sales from the funds and further aligning incentives among investors and advisers, including with respect to the adviser's investment personnel. If such activities were prohibited, this could have the unintended consequence of misaligning adviser and investor incentives.

227. Omitted.

228. Omitted.

229. Omitted.

230. Recognizing the limitations of private fund governance mechanisms, as discussed above, should we permit borrowing if it is subject to specific governance and other protections (e.g., advance disclosure to all investors, advance disclosure to an LPAC or similar body, consent of a governing body such as an LPAC, and/or consent of a majority or supermajority of investors)? Should we require private fund advisers to make ongoing disclosures to investors and/or governing bodies of the status of such borrowings? Why or why not?

See our responses to Questions 224 and 226.

231. Should the rule include any full or partial exclusions for certain transactions that may not involve conflicts of interest or that may involve certain third parties that ameliorate the conflicts of interest? For example, should we provide an exclusion if the terms of the borrowing are set by an independent third party and such third party has the authority to act on behalf of the fund in the event of a default by the adviser? Why or why not?

See our responses to Questions 224 and 226.

232. Do commenters envision unintended consequences of this proposed prohibition, such as in circumstances where an adviser's related person has its own commercial relationship with the fund?

This requirement is overbroad, for example, capturing "indirect" borrowing, which is likely to exclude many investor-favorable arrangements in a manner likely unintended by the Commission. Furthermore, private fund terms often permit advisers to take advances against their share of the fund's assets, including the accrued performance fees or "carry" that the adviser maintains in the fund, for legitimate operating purposes, including to pay tax obligations and to fund employee compensation (e.g., when a payroll provider requires pre-funding but the relevant amounts are invested in the fund in the form of deferred compensation balances or incentive allocations).

233. Omitted.

XII. Responses to the Commission's Questions regarding the Preferential Treatment Rule

General

234. Should the proposed rule apply only to SEC-registered advisers and advisers that are required to be registered with the SEC instead of all advisers, as proposed?

If adopted, the Commission should only apply the Preferential Treatment Rule to SEC-registered advisers. As we discussed Section VI above, exempt advisers are generally not subject to the substantive provisions of the Advisers Act, and investors in funds managed by such advisers should not expect to have the same level of protection as investors in funds managed by registered advisers.

Furthermore, we would again urge that if this rule were adopted as proposed or in modified form, the Commission should explicitly allow for existing fund arrangements to be grandfathered (as discussed in Section XIV below).

235. Should we prohibit all preferential treatment instead of the proposed approach, which is to prohibit certain types of preferential treatment (i.e., liquidity and transparency terms that an adviser reasonably expects to have a material, negative effect) and prohibit all other types of preferential treatment unless disclosed? Why or why not?

The Commission should not prohibit all preferential treatment. As the Commission itself notes, advisers provide a range of preferential treatment, including preferential treatment that does not disadvantage other investors.[98] Furthermore, there are good reasons to permit preferential treatment, including most notably the benefits of such provisions to investors, including investors that do not necessarily get the direct benefit of preferential terms. The Commission recognizes that an adviser may sign a side letter with a large, early-stage investor that results in an increase in the fund's assets such that it can make certain larger investments which ultimately benefit all investors. If advisers were prohibited from providing preferential treatment, many prospective large private fund investors may allocate their capital away from private funds and into separately managed accounts and/or other types of investments for which they are able to secure their preferred terms. This would increase costs, create many potential conflicts of interest, and/or make it more difficult for advisers to get seed and early-stage capital for their funds and scale them such that other private fund investors can receive the benefit of large, profitable investments. Furthermore, investors in existing open-end funds no longer able to receive preferential treatment may respond by redeeming out of the fund, which, particularly if such investor is a large investor, may materially impact the ability of the fund to continue to operate, harming all investors.

We would request clarification from the Commission that liquidity terms set out in a private fund's governing documents (for example, multiple share classes that offer different redemption terms) would not be considered "preferential" rights for purposes of the proposed rule, as it appears that the Commission intended to limit the scope of arrangements that are subject to the Preferential Treatment Rule to arrangements agreed to separately with individual investors outside of the private fund's governing documents. Clarifying this point is critically important, and we therefore ask the Commission to do so as part of any final rulemaking.

236. Should the proposed prohibitions apply only to terms that the adviser reasonably expects to have a material, negative effect, as proposed? Alternatively, should the proposed prohibitions apply more broadly to terms that the adviser reasonably expects could have a material, negative effect? Why or why not?

We would strongly recommend against applying the broader formulation of the proposed prohibitions, and would instead urge the Commission, if it ends up prohibiting these types of preferential treatment, to narrow the application of the provision to those terms that the adviser knows will have a material, negative effect. The prohibitions, as currently formulated, are likely to result in widely varying interpretations by advisers. Some advisers may view them as precluding any terms where a material, negative effect is reasonably foreseeable or even possible (rather than expected), even if the actual risk of such effect is very low and even where the immediate and actual benefits to investors of the proposed term outweigh the possible costs (if any). The current formulation also presents a greater risk that the Commission will second-guess, with the benefit of hindsight, the adviser's original determination in the event of losses or other negative fund events. Additionally, to further mitigate regulatory and other risks associated with the new prohibition, advisers may take an overbroad view of what is a *substantially similar pool of assets* and include vehicles with materially different characteristics.

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98 Proposing Release, *supra* note 3, at 16928.

As a result, the overall effect of the prohibitions will be to (i) in the case of preferential liquidity, reduce overall investor liquidity and have other negative consequences for investors and (ii) in the case of preferential information, chill communications with investors and prohibit many investors from receiving vital information (including information that they may need pursuant to state law or their own internal policies).

237. Should we prohibit all preferential liquidity terms, rather than just those that the adviser reasonably expects to have a material, negative effect on other investors in that fund or in a substantially similar pool of assets? Why or why not?

The Commission should not prohibit all preferential liquidity terms, as such a prohibition could capture commonly offered accommodations such as redemptions in amounts less than the minimum provided for in the fund documents and waivers of notice/gating requirements in the context of share class exchanges. These are examples of accommodations that all private fund investors may have occasion to benefit from.

We also believe, however, that the Commission should reconsider the prohibition on preferential liquidity terms as proposed. Our view is that such a prohibition would in fact reduce investor liquidity and have other unintended consequences, particularly where certain advisers interpret the prohibition in a manner such that it effectively ends up being treated as a *de facto* prohibition on any different liquidity terms. While we believe this is problematic for all funds and advisers, there are particular situations in which the consequences may be particularly significant.

The definition of "substantially similar pool of assets" captures investment policies, objectives or strategies, but understandably, not fund terms. As outlined in our response to Question 247 below, we request that the Commission clarify this defined term. Currently, advisers have the flexibility to offer investors a range of liquidity terms, even between funds with similar mandates. The proposed rule, however, would result in fewer liquidity options for investors by potentially forcing uniformity across multiple vehicles. This could result in options that are more permissive or restrictive than may be appropriate for investors in each individual vehicle. As defined, "substantially similar pools" explicitly excludes funds registered under the Investment Company Act but appears to include similar types of funds such as UCITS and would also seem to encompass non-U.S. funds with no U.S. investors. We believe that these types of vehicles should not be considered "substantially similar" to a private fund, such that their liquidity terms should be aligned in this manner.

Notwithstanding the fact that the Proposing Release's discussion accompanying this rule appears focused on preferential treatment of investors, there is actually no reference in the rule itself to disparate treatment. As a result, there is not insubstantial risk that the Commission may use the event of a fund's redemption-related losses to argue after the fact that the fund's redemption provisions were too permissive and thus the adviser should have reasonably expected them to have a material, negative effect on other investors, notwithstanding that at the time they were granted the adviser (and the private fund's investors) took a different view.

If the Commission ultimately decides not to withdraw this rule, as we would urge it to do, we request confirmation that terms included in a private fund's governing documents and, thus, disclosed to all investors will not be subject to this rule.

In particular, the Commission should explicitly clarify that different liquidity terms may be provided to investors in different fund classes or series without being considered preferential, especially since such terms are likely to be disclosed in the fund's offering materials. In this instance, *all* investors in the fund are given the option to choose what liquidity terms they prefer (within the fund's governing and offering documents), and it would not make sense to capture this in the Preferential Treatment Rule.

238. Are there certain investors who require different liquidity terms (e.g., ERISA plans, government plans)? If so, which types of investors and what liquidity terms do they require? How do advisers currently accommodate such investors without disadvantaging other investors in the private fund? Should the proposed rule permit different liquidity terms for these investor types? If so, should the proposed rule impose restrictions in order to protect other private fund investors? If so, which types of restrictions?

The Commission should explicitly permit different liquidity terms where such terms are given in connection with laws, regulations, policies and/or governing documents applicable to the particular investor. Failure to do so would preclude such investors from investing in certain funds or force them to invest on terms that are disadvantageous compared with the rights they currently have when investing. To cite two examples, in the case of ERISA plan investors or investors subject to the Bank Holding Company Act, the fund may need to impose different redemption/withdrawal requirements in order for the fund (i) in the case of ERISA investors, to not be deemed to have "plan assets" such that the fund is subject to substantive prohibitions and limitations under ERISA, or (ii) in the case of Bank Holding Company Act investors, to be deemed to be controlled by a bank and thus itself subject to the Bank Holding Company Act. For the avoidance of doubt, such redemption/withdrawal provisions would benefit not just ERISA and Bank Holding Company Act investors, but rather the fund as a whole (and thus all investors) insofar as being subjected to such rules is likely to impose various unwanted costs and restrictions on the fund.

239. Are there practices related to liquidity and redemption rights that the proposed rule should explicitly address (e.g., in-kind distribution of securities in connection with a redemption, side-pocketing of illiquid investments, discounting or eliminating the management fee while a fund suspends liquidity)? For example, should the proposed rule prohibit in-kind distribution of securities in connection with a redemption, side-pocketing illiquid investments, or discounting or eliminating the management fee while a fund suspends liquidity? Alternatively, should the proposed rule include an exception for these activities?

We do not believe that in-kind distributions of securities in connection with a redemption and side-pocketing illiquid investments should be prohibited as these are important tools for advisers to use to manage a fund's liquidity (often at crucial periods).

240. Should we prohibit all preferential transparency regarding holdings or exposures of the fund or pool, rather than just prohibiting preferential transparency regarding holdings or exposures that the adviser reasonably expects to have a material, negative

effect on other investors in that fund or in a substantially similar pool of assets? Why or why not?

The Commission should not prohibit different treatment with respect to providing investors with information regarding holdings/exposures. While the Commission argues that such a prohibition is designed to prevent "disparities in treatment of different investors…where the disparity is due to the adviser *placing their own interests ahead of the client's interests*…,"[99] it ignores the fact that it is more often than not *investors* that seek such terms from advisers because it is in the investor's interest to do so. Many investors find tailored holdings/exposure information essential for their own portfolio management purposes, as well as to meet certain compliance needs (e.g., with respect to certain investment restrictions). Not all investors have the same informational needs, which is why certain investors value these types of preferential terms much more highly than others. This prohibition would have a chilling effect on the ordinary course adviser/investor communications regularly sought by investors. If advisers are unable to accommodate tailored informational requests from investors because of concern that they will run afoul of this prohibition, investors may find it more difficult to gain necessary visibility into their investments. An example of such differential information need may relate to investors that are prudentially regulated such as insurance companies that may need to obtain a higher level of granularity or certain portfolio risk metrics required for them to achieve a more favorable capital treatment for their investments.

The logic used by the Commission in its determination to exclude one-on-one communications from the definition of "advertisement" for purposes of the Marketing Rule applies here as well. The Commission excluded such communications "to avoid the possibility that the rule would impede typical communications between advisers and their existing and prospective investors" as "[a]n adviser might have been dis-incentivized to communicate regularly with its investors if it believed it would have to analyze every communication for compliance with the proposed rule."[100] Sophisticated institutional investors in private funds, the Commission recognized, often seek specialized information (such as hypothetical targets and projections) in order to properly evaluate their investments. There is no justification for hindering this type of engagement between advisers and investors as the prohibition almost certainly will.

For the same reasons, the rule should not be applied to "substantially similar pools of assets."

241. Should we define, or provide guidance on, when preferential redemption terms or preferential information rights would have a material, negative effect on other investors? If so, what should be some determining factors? Would it be relevant that the redemption terms would cause another investor to reconsider its investment decision? Please explain your answer. Should we clarify whether an adviser could disclose information about holdings or exposures of the fund or a substantially similar pool of assets on a delayed basis without violating the proposed prohibition? Should

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99 Proposing Release, *supra* note 3, at 16951.

100 Marketing Rule, *supra* note 5, at 13030.

the proposed rule expressly require disclosure to investors after a specified period? If so, what period?

If the Commission ultimately adopts the Preferential Treatment Rule as proposed, advisers will need additional guidance. Given that such preferential rights have been part of market practice for decades, advisers would benefit from understanding how the Commission would assess this standard. As a general principle, we believe the materiality of preferential redemption terms or information rights should be assessed in the basic framework under the securities laws (i.e., whether there is a substantial likelihood that a reasonable investor would consider such terms significant in their decision to invest or remain in the fund). This would allow the adviser to objectively assess the relevant facts and circumstances and consider both quantitative and qualitative factors in determining whether the prohibition should apply to the particular term.[101]

Furthermore, we would recommend that the Commission consider incorporating certain safe harbors into the rule, so that an adviser can engage in certain activities (such as disclosure on a delayed basis as described in the question) without concern that they will violate the prohibition.

242. Omitted.

243. Omitted.

244. Should we restrict the use of side letters and side arrangements so that they can only be used to address certain matters such as, for example, legal, regulatory, or tax issues that are specific to an investor?

Notwithstanding the specific prohibitions and disclosure requirements, our view is that the Proposal already would create a *de facto* restriction on the use of side letters and side arrangements beyond what the Commission has intended. This will result in private funds being both less transparent and less investor friendly. The Commission does not define what it means for a term to be "preferential" but rather leaves it up to the adviser to make such determination depending on the facts and circumstances. Moreover, unlike the preferential liquidity and informational prohibitions, the disclosure provision is not subject to a "materiality" standard, which could lead to an overbroad interpretation of what terms are "preferential" and thus result in a number of unintended consequences.

As a general matter, we believe that the vast majority of private fund side letter terms do not harm other investors, even if they would technically be deemed "preferential" under the Proposal. These include, among others, the right for an investor to assign its interest to an affiliate, confidentiality rights and terms related to disclosure in connection with state pension plan investors. Entering into side letters is a common practice because they are generally a low-cost way for the adviser to meet the specific preferences of individual investors. However, many advisers are likely to respond to the new requirements under the Proposal by cutting back on such arrangements and making it more difficult for investors to negotiate for preferential terms. In order to comply with the Proposal, advisers may be effectively compelled to provide "most favored nation" ("MFN") rights to

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[101] *See*, *e.g.,* SEC, Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors (March 9, 2022).

all prospective investors in a fund. Because an adviser would be prohibited from providing preferential treatment without disclosure of such in advance to prospective fund investors, advisers to closed-end private funds will be required to run a *de facto* MFN election process prior to the first closing of the fund. While all investors may not have an MFN *right*, it is likely that any number of investors will seek to receive some or many of the terms granted to other investors, whether or not such terms actually bring any material benefit to the requesting investor. While advisers may be willing to assume the costs of providing certain terms to a small number of investors that highly value a particular term, they may not be able to for all investors, some or many of whom are not likely to value the term as highly. Furthermore, as side letters are negotiated up until closing, the Proposal could make it more difficult to close the fund, and advisers will likely need to impose a quiet period prior to closing. It is easy to imagine the substantial costs in both time and money that the disclosure requirement will impose on advisers. In combination with the uncertainty around whether a term is "preferential," advisers may simply respond by no longer offering investors the ability to enter into side letters.

The Proposal will also disadvantage some investors. Many investors, for confidentiality or other reasons, may not want the terms they have negotiated with advisers to be disclosed to all investors. Investors that currently receive preferential terms will see the value of their bargain diminished if other investors are able to see and ask for the same terms. Certain large investors may only invest in the first place because they have the ability to receive preferential terms in a side letter that differ from those of other investors. As we have discussed elsewhere, this often enables a fund to make larger, more profitable investments that benefit all investors. Other investors, therefore, enjoy the benefit of the bargain between the adviser and the larger investor, even if they do not receive the same preferential terms. It is not clear why the Commission believes disadvantaging seed or strategic investors, or those willing to make large commitments to the fund, will be a net positive for other investors.

Aside from the impact on side letter arrangements, and perhaps more troublingly, the Proposal would likely chill communications and other ordinary course interactions between advisers and investors by imposing a Regulation FD-like regime where any non-uniform disclosure may be considered no longer permissible. As drafted, the Proposal is not limited to disclosure of preferential treatment provided to investors in a side letter or other written agreement but could capture all types of informal accommodations that advisers routinely give to investors. Investors frequently ask for and receive different types of information regarding the funds in which they invest (e.g., tax information, updates on current events, responses to periodic investor-specific due diligence questionnaires) that may arguably now be considered "preferential" and thus disclosable under the Proposal. Advisers may also agree in the ordinary course of business to waivers and other accommodations for particular investors, such as waiving certain thresholds, extending capital contribution deadlines and/or permitting in-kind contributions or distributions. These information requests and accommodations are valuable to investors and provide them with important benefits, yet it is likely that if each such request or accommodation must be disclosed, investors may eliminate or otherwise restrict them.

245. Should the rule's prohibitions on preferential terms extend to a substantially similar pool of assets or apply only to each private fund separately?

We believe that the term "substantially similar pool of assets" is overbroad and, when applied in this context, is likely to result in investors being subject to unreasonable limitations on liquidity and informational rights as a result of an over-aggregation of vehicles for purposes of compliance by some advisers. We request that the Commission define the term "substantially similar pool of assets" to only include pooled investment vehicles that are designed to invest *pari passu* with each other. As discussed elsewhere in this letter, there may be justifiable reasons why investors in different vehicles are given different liquidity terms and information, notwithstanding similarities in their investment strategies or objectives, and, depending on the relationship between the two vehicles, there may be a low risk that prohibited "preferential" treatment given to an investor in one would have a material, negative effect on other investors.

246. The proposed definition of "substantially similar pool of assets" would not include co-investments by a separately managed account managed by the adviser or its related persons. Is this definition too narrow? Why or why not? Would the proposed definition appropriately capture similar funds? Should it, for example, include circumstances where a private fund invests alongside a separately managed account? Why or why not? Should the definition include a co-investment vehicle that is structured as a pool of assets that invests in a single entity and where the private fund invests in the same entity?

Separately managed accounts should not be included in the definition of "substantially similar pool of assets". If separately managed accounts were covered by this rule, they would effectively be banned by it. Separate account owners, by nature, see all portfolio holdings and exposures in the account because they are the accountholder. Moreover, a separate account owner, by nature, can revoke the adviser's authority to manage the account at will, even if there are longer liquidity provisions agreed upon in the relevant private fund documentation. Therefore, if the Proposal is effectively transforming *different* transparency and liquidity into "*preferential*" transparency and liquidity, the existence of one separate account managing a particular strategy would potentially mean that every commingled fund pursuing a similar strategy would either have to provide daily liquidity and complete transparency into account-level data, or the separate account would have to be closed.

Co-investment vehicles should also be excluded from the definition of "substantially similar pool of assets".

247. Should we limit "substantially similar pool of assets" to pools the adviser or its related persons manage, as proposed? Is the proposed definition too broad or too narrow? The proposed definition would require the pool of assets to have substantially similar (i) investment policies, (ii) objectives, or (iii) strategies to those of the private fund. Should we change "or" to "and" and instead require that the pool satisfy all three requirements (i.e., have substantially similar investment policies, objectives, and strategies)? Should we instead require that the pool satisfy only two of the three criteria? For example, should the definition only require the pool of assets to have substantially similar objectives and strategies (and not policies) to those of the private fund? Are there other unique characteristics or factors, such as the target rate of

return, the proposed definition should address? Should the definition exclude multi-share class private funds? If so, why?

Yes, the proposed definition of "substantially similar pool of assets" to pools the adviser or its related persons manage is too broad. If the Commission adopts this rule in some form, we suggest that the Commission define the term "substantially similar pool of assets" to only include pooled investment vehicles that are designed to invest *pari passu* with each other, as such vehicles are more likely to have a similar risk/return profile to the private fund such that the treatment of investors in those vehicles will be more relevant to the private fund's investors. Furthermore, if funds registered under the Investment Company Act (such as mutual funds) are excluded[102], then UCITS funds and other non-U.S. regulated collective investment vehicles should be excluded as well. We request that the Commission clarify that different pooled vehicles with similar investment strategies and underlying portfolios will not be deemed to be "substantially similar pools" even if there is some overlap between the pools in respect of their portfolios if they were not designed to invest *pari passu* with each other. We would also support the exclusion of multi-share class private funds.

248. Should we narrow the scope of the term "substantially similar pool of assets" to only include pooled vehicles that invest or generally invest pari passu with the private fund? Why or why not?

See response to Question 247.

249. Omitted.

250. Instead of requiring advisers to provide or distribute the written notice, should we require advisers to only provide or distribute the written notice upon request?

If the Commission adopts this rule in some form, we will support a modification to the effect that advisers would only be required to provide or distribute the written notice upon request. This would not only reduce the burden on advisers but would empower investors to decide for themselves whether this information is important to them such that they will invest the time and resources into understanding and considering it in relation to their investment. This is also the approach taken in connection with other matters such as the adviser's code of ethics and proxy voting policy, as well as information related to hypothetical performance under the Marketing Rule.

Alternatively, if the Commission retains the requirement that investors must provide or distribute the written notice, we recommend that it explicitly allow advisers to make it available in a data room, where appropriate.

251. With regard to current investors, the proposed rule would require advisers to disclose preferential treatment provided by the adviser or its related persons. Instead or in

102 Proposed Rule 211(h)(1)-1.

addition, should we require advisers to disclose preferential treatment that it has offered to other investors in the same fund?

If the Commission adopts this rule in some form, we believe that current investors should only receive disclosure of preferential treatment actually *provided* to other investors in the same fund. Requiring disclosure of all preferential treatment that the adviser has offered to (as opposed to *agreed* with) other investors in the same fund would be extremely burdensome in light of the factors discussed elsewhere (scope of communications, broad definition of preferential treatment) without much benefit to other investors given that such preferential terms were not actually agreed to.

252. Should we require advisers to provide advance written notice to prospective investors, as proposed? Should we define "prospective investor" in the proposed rule? If so, how should we define this term and why? For example, should we define "prospective investor" as any person or entity that has expressed an interest in a private fund advised by the adviser? If not, should we provide guidance regarding how advisers can identify prospective investors? Should we clarify how advisers that use intermediaries, investment consultants, or other third parties to introduce prospective investors would comply with the proposed rule? For example, should we state that advisers must treat the intermediaries, investment consultants, or other third parties as the prospective investor in these circumstances? Should the definition include prospective transferees? Why or why not?

We again point out that this advance written notice to prospective investors requirement would unnecessarily place substantial burdens on the process of negotiating and closing the fund (as discussed above in our answer to Question 244) and would thus urge the Commission to withdraw this rule. If it declines to do so, however, we believe that the requirement should be limited to only those prospective investors that ultimately subscribe for interests in the applicable private fund. Defining "prospective investor" as any person or entity that has expressed an interest in a private fund advised by the adviser would be significantly too broad. We believe that such an expansive definition would have the potential to lead to situations in which a prospective investor is given valuable insight into the adviser's negotiations with investors without providing a corresponding benefit to the adviser of actually receiving an investment from the relevant investor. This might incentivize prospective investors to express interest in private funds in which they are unlikely to invest in order to receive the benefits of disclosure, which would result in inefficiencies for both the adviser and those other investors that ultimately do invest in the fund. Limiting the definition of prospective investors to those that ultimately invest would help advisers avoid this problem.

We would urge the Commission not to include prospective transferees as prospective investors, as certain transfers occur by operation of law and not pursuant to any fund agreement. Furthermore, intermediaries, investment consultants or other third parties should not in any circumstances be treated as prospective investors under the Proposal.

253. The proposed rule would require the adviser to provide the written notice "prior to the investor's investment in the private fund." Should we prescribe how far in advance of

the investment an adviser must provide such notice? For example, should we require an adviser to provide the written notice at least two business days prior to the date of investment? Should such period be longer or shorter? If so, why? Should the proposed rule require advisers to provide notice to prospective investors within a certain number of days before the investor submits its complete subscription agreement (or equivalent)? Alternatively, should the proposed rule require the adviser to provide the notice at the time an investor receives the private fund's offering and organizational documents (e.g., limited partnership agreement, private placement memorandum)? Should we instead require that notice be sent prior to some other action or event? If so, what action or event and why? Should the proposed rule require advisers to update disclosure they previously provided, for example, to include preferential treatment that an adviser granted after some investors decided to invest, but before closing?

As noted, the proposed rule would require the adviser to provide the written notice "prior to the investor's investment in the private fund", however, we believe this should instead be phrased as "prior to the investor's ***initial*** investment in the private fund". The requirement for pre-investment disclosure should not apply to top-up or other subsequent investments in the same fund. With respect to the timing of the pre-investment written notice, see our response to Question 252.

254. What impact would the advance written notice requirement have on "most favored nation" clauses ("MFN clauses") granted to other fund investors?

Please see our response to Question 244.

255. Should the rule require disclosure of all preferential treatment, as proposed, or should the rule have a narrower or broader scope?

Please see our response to Question 244.

256. Should the proposed rule require the adviser to disclose how it memorialized the preferential treatment (e.g., formal written side letter, email)?

In weighing the costs and benefits of this proposed requirement, it is not clear how the method of memorialization would be useful to investors (since the ultimate fact of the preferential treatment does not change with the method) compared with the added compliance burdens on advisers. We would, therefore, encourage the Commission not to prescribe such a requirement if it adopts the rule.

257. Omitted.

258. The proposed rule would require the adviser to provide notice on an annual basis to current investors, if the adviser or its related persons provided any preferential treatment to other investors in the same private fund since the last written notice. The proposed rule does not specify whether the adviser must provide this on a calendar year basis, the adviser's fiscal year, or on a rolling annual basis. Should the rule specify precisely when the annual period begins and ends? Why or why not? If so, what should the beginning and ending dates be? Instead of an annual notice, should

we require an adviser to provide the notice within 30 days of providing any new preferential treatment to an investor in the fund?

If the Commission adopts this rule in some form, all that should be required is that the notice be given on at least an annual basis, as currently proposed, with the adviser given the flexibility to determine when this period will begin and end.

259. Should we require an adviser to document the years during which it has not provided any preferential treatment and therefore need not distribute or provide a written notice to current investors or prospects, respectively? Why or why not? If an adviser has not provided preferential treatment to any investors, or has not done so during the applicable time period, should we require an adviser to send current investors and prospects a written notice confirming that it does not have any preferential treatment to disclose? Why or why not?

If the Commission adopts this rule in some form, we do not believe that such documentation or notice should be required, as such requirements would impose additional unnecessary compliance costs on advisers. The proposed rule imposes an affirmative obligation on advisers to provide annual written notice regarding preferential treatment given since the last written notice. Investors are sophisticated enough to infer that if no notice is provided, no preferential treatment has been given. The Proposal also already requires advisers to maintain a copy of any such notice, which would provide enough information as to when preferential treatment was and was not given to investors in the fund.

260. Omitted.

261. Omitted.

262. Would advisers face more difficulty retaining records regarding prospective investors as compared to retaining records for current investors? Would it be more difficult for advisers to keep track of prospective investors? For example, prospective investors may express interest in a private fund, but may not actually invest. Should we only require advisers to retain records regarding prospective investors that invest in the private fund?

Depending on the particular data protection rules to which an adviser is subject to in a given jurisdiction, requiring the adviser to retain records regarding prospective investors that do not ultimately invest in the fund may conflict with other legal obligations applicable to the adviser. Furthermore, it is not clear what the rationale would be for retaining such records if the prospective investor does not end up investing in the fund, and, thus, did not end up receiving any preferential terms and could not possibly be harmed by preferential terms granted to others.

In addition, if the information is required to be provided to a third party allocator separate from the requirement to provide it to investors (which it should not be as third party allocators are not the actual investors), the fund would likely not have any knowledge of who the information was provided to and would thus be unable to keep records on such persons as prospective investors.

263. The books and records rule under the Advisers Act applies to SEC-registered advisers. Should we adopt a recordkeeping obligation that would require other advisers (such as exempt reporting advisers) to retain the written notices that proposed rule 211(h)(2)-3 would require? Why or why not?

As the Commission notes, the books and records rule only applies to SEC-registered advisers, and we do not believe that the Commission should establish the precedent of having it apply to unregistered advisers, including exempt reporting advisers.

XIII. Responses to the Commission's Questions regarding Written Documentation of Adviser Compliance Reviews

264. Omitted.

265. Should we specify certain elements that must be included in the written documentation of the annual review? For example, should we require the written documentation to address matters similar to those that are required in the CCO's written report to a registered fund's board of directors pursuant to rule 38a-1 under the Investment Company Act? Despite the limitations of private fund governance mechanisms, as discussed above, should we require the new documentation to be provided to LPACs, directors, or other governing bodies of private funds? Why or why not?

The Commission should not specify particular elements, but rather leave it up to advisers to determine what is material and relevant in the context of their particular business. We would note that Rule 38a-1 of the Investment Company Act is designed to address funds with a different type of investor base (i.e., retail investors), and believe that imposing Investment Company Act-like requirements on funds excluded from the Investment Company Act undermines the purpose of such exclusions.

266. Omitted.

267. Omitted.

XIV. Responses to the Commission's Questions regarding the Transition Period and Compliance Date

General Comment on the Prohibited Activities and Preferential Treatment Rules

Despite the scope of the Proposal, the Proposing Release does not offer any grandfathering with respect to existing private funds and existing contractual arrangements. The effect of the Proposal's outright bans on certain types of terms and activities, including many that are commonplace in the private fund market and beneficial for investors, would call into question the status of certain terms incorporated into tens of thousands of agreements and other documents (including but not limited to confidentiality provisions) which may not actually become void by operation of law based on the current Proposal, on the day the new rules come into effect. These were terms that both investors and advisers agreed to at a time when they did not violate, and would not have been deemed to violate, any requirements applicable to the adviser under the

Advisers Act. The Commission's Proposal also ignores that these terms were not agreed into in isolation, but rather as part of a comprehensive package of terms, negotiated by way of an iterative process of give and take between investors and advisers. Although the prohibitions only have the effect of invalidating certain terms, they nevertheless meaningfully alter the overall bargain, such that the entire negotiated relationship between the adviser and the fund's investors is thrown out of balance.

Historically, the Commission has sought to "minimize the disruption" to existing contractual arrangements that were permissible at the time that they were entered into[103] either by providing for grandfathering[104] or permitting an adviser to operate and perform under the contract (without requiring the adviser to modify it) as if it contained or otherwise reflected the specified provisions.[105]

The consequences, both foreseen and unforeseen, of a lack of grandfathering with respect to the Prohibited Activities and Preferential Treatment Rules could be disastrous for funds, advisers and investors. With key negotiated preferential terms now no longer permitted, investors who lose the benefit of their bargain may redeem out of open-end funds, and advisers are likely to face a wave of redemption requests. Such investors may also be subject to redemption fees, anti-dilution levies and redemptions in-kind. Where the prohibited terms (including related confidentiality agreements) are not voided by operation of law and investors choose not to agree to renegotiate, advisers will be left with the poor options of:

- a regulatory breach;
- breach of contract;
- involuntary redemption of those investors (where permitted); or
- shuttering the fund where involuntary withdrawal is not an option.

All of these are poor outcomes for investors, as well as for advisers.

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103 *See*, SEC, Investment Management Staff Issues of Interest: Advisory Contracts — Transition for Newly Registered and Registering Advisers (March 30, 2012).

104 *Id*. Specifically, the Commission cited to Investment Advisers Act Release No. 2333 (Dec. 2, 2004), in which the Commission adopted rules to grandfather pre-existing contractual arrangements providing for performance-based compensation that were entered into when the adviser was exempt from registration and Investment Advisers Act Release No. 3372 (Feb. 15, 2011), in which the Commission adopted rules to grandfather pre-existing performance fee contractual arrangements that satisfied the requirements of the rule at the time that the contract was entered into.

105 *Id*. The applicable guidance provided that the staff would not recommend enforcement action to the Commission under Sections 205(a)(2) and (3) of the Advisers Act if an adviser that applied for registration but was not registered, nor required to be registered, when it entered into its advisory contracts, did not amend an advisory contract to include the provisions required by Sections 205(a)(2) and (3) *and* complied with certain specified conditions, including undertaking to operate and perform under the advisory contract as if it contained the provisions specified in Sections 205(a)(2) and (3) and, in the case of a private fund client, disclosing such undertaking each investor (or independent representative of the investors) in the private fund. We would note, however, that such an approach may be undesirable in the case of the Prohibited Activities Rule, because a non-adviser succeeding to the adviser's rights under its advisory contracts, such as a trustee or receiver in a bankruptcy or insolvency proceeding, would not be subject to the Advisers Act and could well be entitled to enforce the specified provisions as written.

Considering the number of funds that the Proposal will impact, and the likelihood that this redemption activity occurs within a short period of time (given the 12-month transition period provided for in the Proposal), we are concerned about the possibility of a systemic impact across the market as advisers liquidate portfolios and implement suspensions and gates.

Where a renegotiation is required, investors may also seek to renegotiate other terms in order to compensate for the loss of the previously agreed but now prohibited terms. Moreover, certain investors may be forced into a position of non-compliance with their own policies to the extent that their individual liquidity or reporting provisions are considered preferential and to have a material, negative effect on other investors. Larger investors may respond to these changes by moving their assets out of private funds and into separately managed accounts, which would allow them to preserve the rights provided pursuant to such terms, but which would disadvantage those smaller investors for whom that arrangement may not be feasible and who now are left in a fund with reduced assets and higher per share costs. Certain funds may not be in a position to continue, due to the substantial reduction in their assets, following voluntary investor redemptions resulting from offsetting changes that managers will surely make to compensate for the Commission-mandated changes as well as involuntary withdrawals of investors that are unwilling or unable to agree to such offsetting changes.

Furthermore, advisers will need to review and, potentially, amend all fund documents to make sure that they no longer contain any prohibited terms, the cost of which is likely to be staggering. A re-papering strategy would be extremely difficult, if not impossible, to pursue with respect to closed-end funds, as it would require investor consent, which could be withheld or delayed, reasonably or not. As noted above, existing confidentiality provisions in side letters would be called into question to the extent that the terms of such side letters would be considered preferential treatment, as advisers would have to assess whether compliance with such terms would be possible prior to disclosure to other investors, as the Preferential Treatment Rule would require.

Advisers would also need to assess whether to re-structure their fee and expense models to compensate for the additional costs of compliance and the fact that they are no longer able to charge the fund for certain fees and expenses nor reduce clawbacks to account for taxes. Furthermore, by prohibiting advisers from limiting their liability for certain types of conduct, including ordinary negligence, advisers will now be subject to a substantially increased risk of liability for routine decisions on operational matters, without having first negotiated fee and expense provisions to compensate for that heightened liability risk and to allow the adviser to purchase additional insurance coverage or fund an increase in contingency reserves.

Due to the wide-ranging impact of the Proposal, adviser resources will be diverted from managing funds to re-papering contracts, dealing with redemption requests, seeking new investor consents, managing the risk of increased liability for business decisions and/or otherwise ensuring compliance with the Proposal. Investors will also necessarily incur costs associated with their own review and negotiation of amended fund documents and consent solicitations across their entire private fund portfolios. The Commission fails to take these inevitable costs into account in its cost-benefit analysis. See also the discussion of unintended consequences in Section II above.

268. **Do commenters agree that a one-year transition period following each rule's effective date if adopted is appropriate? Should the period be shorter or longer? For example, would six months be an appropriate amount of time? Alternatively, would eighteen months be necessary?**

In light of the substantial new requirements imposed by the Proposal and the challenges described above, we would request that the Commission provide advisers with a transition period of no less than 36 months following each rule's effective date. The Marketing Rule, which was far narrower in scope than the Proposal, provided advisers with an 18-month transition period. See also our response to Question 269 regarding the grandfathering needed in order that a substantial wave of redemptions at the option of the investors and forced redemptions is not triggered which could destabilize funds and perhaps even markets.

269. **Should the transition period be the same for all of the proposed new and amended rules if adopted? Should we have different compliance dates for each proposed rule? Why or why not, and for which rules?**

With respect to the Prohibited Activities and Preferential Treatment Rules, we would strongly urge the Commission to grandfather in perpetuity all funds and fund-related agreements existing prior to the effective date of the rules.

With respect to the Mandatory Audit Rule, we would recommend that advisers only be required to comply with the audit requirement beginning with the first full fiscal year starting on or after the compliance date.

270. **Should the transition period be the same for all advisers subject to the proposed rules, if adopted? Alternatively, should we adopt a tiered transition period for smaller or larger entities? For example, should we provide an additional six months in the transition period for smaller entities (or some other shorter or longer period)? How should we define smaller entities for this purpose?**

See our response to Question 269.

271. **Should advisers to certain fund types have a longer (or shorter) transition period? Would compliance with some or all of the proposed rules be more complex for advisers to certain fund types, such as private equity, venture capital, real estate or other similar closed-end private funds, than for advisers to other fund types, such as hedge funds or other similar open-end private funds?**

See our "General Comment on the Prohibited Activities and Preferential Treatment Rules" above.

272. **The proposed quarterly statement rule would require advisers to report performance since the fund's inception. Should we allow funds that existed before the compliance date of the proposed rule to include performance information only for periods beginning on or after the proposed rule's compliance date? Should the proposed rule include a maximum period of time that funds that are in existence as of the compliance date must look back in order to report performance, fees, and expenses?**

Is it common practice for older funds (e.g., hedge fund incepted 30 years ago) to retain records to support that performance? Would it be burdensome for advisers to provide since-inception performance information?

Given that advisers may not have been computing performance data in the manner required by the Proposal, and, as such, might have to adopt new policies, systems, etc., we believe that funds existing prior to the compliance date of the proposed rule should only be required to include performance information for periods beginning on or after the compliance date. Moreover, the reportable periods should be limited as discussed in our response to Question 58.

XV. Responses to the Commission's Questions Related to Cost Benefit Analysis

The Commission's recent rulemaking process has given the industry insufficient time to fully assess the impact (both individually and collectively) of such proposals and thoughtfully consider less burdensome alternatives. The Commission's cost benefit analysis reflects little if any advance research about the potential impacts of the Proposal. Although the questions below request additional information, we submit that this information should have been sought prior to the publication of any proposal after allowing sufficient time for industry to gather relevant information, not after the proposal has been made and on a short deadline. We would urge the Commission to pause this rulemaking process and instead to engage with private fund advisers and investors to gather additional information regarding the likely consequences and related costs and benefits of the proposed rules and, ultimately, to consider a more flexible, principles-based approach, emphasizing disclosure, following that research effort.

273. Omitted.

274. Has the Commission accurately characterized the costs and benefits of proposed rule? If not, why not? Should any of the costs or benefits be modified? What, if any, other costs or benefits should the Commission take into account? If possible, please offer ways of estimating these costs and benefits. What additional considerations can the Commission use to estimate the costs and benefits of the proposed amendments?

Please refer to our discussion in Section IV of this Annex.

275. Has the Commission accurately characterized the effects on competition, efficiency, and capital formation arising from the proposed rules? If not, why not?

Please refer to our discussion in Section II of this Annex.

276. Has the Commission accurately characterized the economic effects of the above alternatives? If not, why not? Should any of the costs or benefits be modified? What, if any, other costs or benefits should the Commission take into account? Are there other reasonable alternatives to the proposed amendments? What are the economic effects of any other alternatives?

Please refer to our discussion in Section IV of this Annex.

277. Omitted.

278. How would the proposed delivery of the quarterly statement affect the reporting practices of advisers, including the costs and benefits of these statements? Would advisers add the required report to the report that they currently provide to investors? Would advisers substitute the required report for an existing report? Explain.

Our view is that, notwithstanding these new requirements, investors in current funds will want to continue to receive the reports currently provided by advisers, particularly where the content and delivery of such reports were negotiated with the adviser. In those situations, it is unlikely that an adviser would substitute the required report for an extensively negotiated existing report (nor that an investor would desire such a substitution). However, investors may request that advisers reconcile the two reports, which would impose substantial additional costs on the adviser and investors. Even if such new costs are not passed onto the fund, as we would expect, investors will have to bear additional internal staff and/or external consulting costs in order to understand the reconciliations between the reports they currently receive and the new (and potentially misleading) information required by the Proposal.[106]

One significant concern we have is that existing side letter arrangements with investors are likely to be considered as disclosable under the Preferential Treatment Rule. If the side letter also includes a confidential treatment provision, and the adviser cannot negotiate the confidential treatment to be released, then the result would be that the bespoke investor reporting could not be provided on the basis that it would be prohibited as undisclosed preferential treatment. The Commission should explicitly clarify that advisers may continue to provide existing reports to investors, in addition to the quarterly statement, notwithstanding that the existing reports may constitute "preferential" reporting under the Preferential Treatment Rule.

For new funds, we would expect that the required report will be the only report provided, especially if such report and any other similar reports are considered an adviser expense and therefore not chargeable to the fund. If other reports are required by investors, the cost of getting an adviser to agree to provide them is likely to be higher, as the preferential treatment disclosure requirement may effectively oblige the adviser to provide such other reports not just to the requesting investor but to all other investors as well. Therefore, at a minimum, the Commission must provide a full exception for advisers utilizing a pass-through expense model.

279. What are the benefits to investors of obtaining the information that would be required under the proposal in a standardized format that would enable them to make comparisons across alternative fund investments? Explain. Would the benefits to investors vary based on the investor's scale of operations, relationship with the adviser, or other factors? Explain. Please provide data, if available, to support your answer along with details regarding data sources and interpretation of statistics, where appropriate.

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106 *See* response to Question 58 with respect to the potential for the hypothetical information required as a result of the mandated assumptions to be misleading.

As discussed elsewhere, we believe benefits of standardized formatting would be very limited and would not provide investors with reports that allow apples to apples comparison of funds.

280. Would the proposed rules strengthen the bargaining power of investors in negotiating with private fund advisers? If so, under what circumstances, and for what types of funds and investors would this effect occur? How would it affect other investors who do not gain bargaining power as a result of the proposed rules? Please explain your answer and provide supporting data, if possible.

To the extent that large investors value any of the "preferential" terms that will be banned (or subject to unwanted disclosure), we anticipate that they may seek to migrate their investing activity into separate accounts so that they can continue to receive their customized terms and reporting. With respect to smaller investors, whose "ticket size" would not justify the costs of opening a separate account, such investors would have less bargaining power with respect to their fund investments.

281. Omitted.

282. Omitted.

283. To what extent do funds currently provide quarterly statements to investors, and what is the cost of providing these statements? How are they delivered? How do investors use them? What are the contents of these statements currently? How do the current contents compare with the contents that would be required under the proposed rule? Explain.

Many private fund advisers provide monthly unaudited NAV statements, which when combined with the annual audited financial statements, is all that should be required.

284. We believe that the information in the new quarterly statements would supplement the information that investors currently receive about their fund investments and that advisers would not respond to the proposal by discontinuing any reports to investors. Is this correct? Why or why not? Please explain.

This may or may not be the case and the outcome may depend on (i) how much of the bespoke reporting could be deemed to be prohibited or disclosable "preferential" treatment, and (ii) whether investor reports that take a different approach from the one mandated by the Proposal would be considered "misleading".

285. Omitted.

286. Omitted.

287. Omitted.

288. Omitted.

289. Omitted.

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293. Omitted.

294. Omitted.

295. Omitted.