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Submitted via email to: rule-comments@sec.gov
Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Proposed Rules and Rule Amendments Regarding Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews [Release No. IA-5955; File No. S7-03-22]

Dear Ms. Countryman:

This letter is submitted on behalf of the Federal Regulation of Securities Committee (the "Committee") of the Business Law Section (the "Section") of the American Bar Association (the "ABA"), in response to the request for comments by the U.S. Securities and Exchange Commission (the "Commission" or "SEC") regarding its proposed rules under the Investment Advisers Act of 1940 (the "Advisers Act") relating to private funds (the "Proposed Rules") that are set out in Investment Advisers Act Release No. IA-5955 (Feb. 9, 2018)[1] (the "Proposing Release"). The comments expressed in this letter represent the views of the Private Funds Subcommittee (the "Subcommittee" or "we") only and have not been approved by the ABA's House of Delegates or Board of Governors, and, therefore, do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section, nor does it necessarily reflect the views of all members of the Committee.

BACKGROUND

On February 9, 2022, the Commission issued six proposed rules and two proposed rule amendments:

- proposed Rule 211(h)(1)-1, which establishes definitions applicable to the other Proposed Rules (the "Definitions Proposal");
- proposed Rule 211(h)(1)-2, which requires the delivery of quarterly statements to private fund investors and specifies requirements for such statements (the "Quarterly Statement Proposal");

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955 (Feb. 9, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-5955.pdf.

- proposed Rule 211(h)(2)-1, which prohibits certain activities by private fund advisers (the "Prohibited Activities Proposal");

- proposed Rule 211(h)(2)-2, which requires a fairness opinion and related disclosures for adviser-led secondary transactions relating to a private fund (the "Adviser-Led Secondaries Proposal");

- proposed Rule 211(h)(2)-3, which prohibits certain forms of preferential treatment that an adviser to a private fund reasonably expects to have a material, negative effect on other investors in that private fund (the "Preferential Treatment Proposal");

- proposed Rule 206(4)-10, which requires an annual audit for every private fund managed by a registered investment adviser (the "Audit Proposal");

- proposed amendments to Advisers Act Rule 206(4)-7, which requires documentation of annual compliance reviews conducted under Rule 206(4)-7; and

- proposed amendments to Advisers Act Rule 204-2, which creates books and records obligations applicable to requirements established by the other Proposed Rules.

The Subcommittee is comprised of attorneys whose clients include private funds and their managers. We appreciate this opportunity to provide our comments regarding the Proposed Rules.

EXECUTIVE SUMMARY

In this letter we address several concerns that we have regarding certain of the Proposed Rules and we respectfully request the Commission consider the following changes:

- The Commission cites the language of section 211(h) of the Advisers Act (Section 211(h)") in promulgating the Quarterly Statements Proposal, Definition Proposal,[2] Prohibited Activities Proposal, Adviser-Led Secondaries Proposal, and Preferential Treatment Proposal but does not elaborate further as to its authority. It is not evident to us upon a review of the legislative purpose of Section 211(h) and other provisions with which the section was enacted by Congress how the section provides authority for these Commission rules. In our view, the context of Section 211 demonstrates that

[2] The Definition Proposal is included in this list because it relates to other Proposed Rules.

Section 211(h) addresses the protection of retail customers, and we believe that the Proposing Release does not adequately address the Commission's authority to issue rules under this provision that would impose sweeping requirements on private fund advisers.

- The Proposed Rules would be inconsistent with the Commission's Interpretation Regarding Standard of Conduct for Investment Advisers (the "Fiduciary Interpretation").[3] After 79 years of the Advisers Act, the Commission for the first time in 2019 identified the requirements of investment advisers as fiduciaries. The Commission did not adopt a series of specific prohibitions and requirements of private fund advisers, or any other group of investment advisers. Fewer than three years later, the Commission is proposing a complete about-face, without identifying any changed facts that would support it.

- If the Prohibited Activities Proposal and Preferential Treatment Proposals are adopted, they should be revised to take the form of disclosure and informed consent requirements with respect to the activities and terms identified in those proposals, and should not take the form of prohibitions. A disclosure and consent approach would be more consistent with the Fiduciary Interpretation.

- If the Prohibited Activities Proposal is adopted, prohibitions should be narrowly tailored to address specific fraudulent practices, for which the Commission has clearer authority to promulgate regulations under section 206(4) of the Advisers Act ("Section 206(4)").

- If the Quarterly Statements Proposal is adopted, it should be revised to require annual reporting of expenses, as opposed to quarterly, and permit advisers greater flexibility in presenting performance information.

- The Commission should consider harmonizing the Audit Proposal with the limited partnership audit option used to satisfy Advisers Act Rule 204-2(a)(4) (the "Custody Rule").

DISCUSSION

I. <u>The Commission Has Not Adequately Explained Its Authority to Issue Certain of the Proposed Rules under Section 211(h) and Section 206(4).</u>

[3] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Release No. IA-5248 (June 5, 2019).

A. Lack of Explanation as to the Commission's Authority to Issue Certain of the Proposed Rules under Section 211(h) and Section 206(4).

The Commission asserts authority to promulgate the Proposed Rules under sections 204, 206(4), 211(a) and 211(h) of the Advisers Act.[4] The Commission does not, however, provide any indication as to how these provisions would support the proposed rulemaking. Without any such explanation, those affected by the Proposed Rules are left without a meaningful opportunity to comment.

Each of the Prohibited Activities Rule, the Adviser-Led Secondaries Rule, the Preferential Treatment Rule, the Quarterly Statement Rule and the Definition Rule, by virtue of the numbering of those Proposed Rules, appears to rely upon the Commission's rulemaking authority pursuant to Section 211(h). We do not believe that the Commission has adequately explained the basis for its authority under Section 211(h) to issue the Proposed Rules. A simple assertion of authority under Section 211(h) does not provide sufficient clarity because the context in which that section was enacted by Congress indicates that it was part of an effort to harmonize standards of conduct between investment advisers and broker-dealers, with the primary focus being the protection of retail investors.

Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[5] imposed registration requirements on many advisers to private funds and in doing so, carefully delineated a single very limited reporting requirement for advisers to private funds – the systemic risk information reported to the Financial Stability Oversight Council on Form PF. In proposing these rules, the Commission appears to ignore the section of Dodd-Frank addressing private fund advisers and instead looks to a section of the statute that never mentions private funds – Section 913 of Dodd-Frank ("Section 913"). Section 913 addressed the protection of retail customers by promoting the alignment of the standards of conduct applicable to brokers, dealers and investment advisers.[6]

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[4] Proposing Release at 325.

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Conf. Rept. 111-517, 111th Cong., 2d Sess. (2010) (hereinafter "Dodd-Frank").

[6] The Conference Report on Dodd-Frank describes the purpose of Subtitle A of Title IX, which included Section 913, as follows:

> "Subtitle A [of Title IX] directs the SEC to study the standards of care applicable to broker-dealers and investment advisers giving investment advice to *retail* customers, and it authorizes the SEC to promulgate rules imposing a fiduciary duty on broker-dealers and investment advisers to protect *retail* customers. . . . Subtitle A also clarifies the authority of the SEC to require investor disclosures before purchase of investment products and services. Finally, the subtitle requires studies on the enhancement of investment adviser examinations, financial literacy, mutual fund advertising, conflicts of interest, improved investor access to information on investment advisers and broker-dealers, and financial planners and the use of financial designations". (emphasis added)." Dodd-Frank at 870.

The title of Section 913 is "Study and Rulemaking Regarding Obligations of Brokers, Dealers, and Investment Advisers". With that title, it is not surprising that the provisions of the section address harmonization of the standards of conduct of broker-dealers and investment advisers.

Section 913 added three provisions to the Advisers Act – sections 211(g), 211(h) and 211(i). Section 211(g)(1) grants the Commission the authority to promulgate rules that harmonize the standards of conduct applicable to broker-dealers and investment advisers, stating the following:

> [t]he Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to *retail customers* (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. *In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer.* (Emphasis added.)

Section 211(g)(2) defines "retail customer" and specifically provides that the term does not include investors in private funds:

> [s]uch rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of this Act when providing personalized investment advice about securities, *except the Commission shall not ascribe a meaning to the term ''customer'' that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.* (Emphasis added.)

Section 211(i) harmonizes enforcement of standards of conduct applicable to broker-dealers and investment advisers, further demonstrating the Congressional intent to protect retail investors:

> the Commission shall seek to prosecute and sanction violators of the standard of conduct applicable to an investment adviser under this Act to same extent as the Commission prosecutes and sanctions violators of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer under the Securities Exchange Act of 1934.

Sandwiched between the two aforementioned sections is Section 211(h),[7] which is inserted below in its entirety:

> (h) OTHER MATTERS.—The Commission shall—
>
> (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and
>
> (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.

It appears highly unlikely that Congress intended to include, in between two sections of the Advisers Act focused on harmonizing standards of conduct applicable to broker-dealers and investment advisers, which both specifically address the protection of retail investors, statutory authority permitting the Commission to impose industry-altering restrictions that solely apply to advisers to private funds, especially in light of Congress' decision to specifically exclude investors in private funds from the definition of "retail customer".[8] Section 211(h) is more reasonably read to complement sections 211(g) and 211(i), which is consistent with the Commission's use of authority granted by Section 211(h) in promulgating Form CRS.

In its study required by Section 913, the Commission did not substantively address private funds in any way.[9] When the Commission adopted rules pursuant to authority conferred under 211(h), they were either of general applicability or focused on retail customers. Indeed, private funds were specifically excluded from the delivery requirements for Form CRS, the

[7] Sections 15(k), 15(l) and 15(m) were also added to the Securities Exchange Act of 1934 (the "Exchange Act") by Section 913. These sections contain language that is substantially similar to sections 211(g)-(i) of the Advisers Act, which is tailored to brokers and dealers. Section 15(l) of the Exchange Act has identical language to Section 211(h). The Commission also issued Regulation Best Interest pursuant to its authority under section 15(l) of the Securities Exchange Act of 1934, which contains the same language as Section 211(h).

[8] Advisers Act § 211(g)(1) ("except the Commission shall not ascribe a meaning to the term [retail] ''customer'' that would include an investor in a private fund managed by an investment adviser").

[9] U.S. Sec. & Exch. Comm'n, Study on Investment Advisers and Broker-Dealers, As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2011), *available at* https://www.sec.gov/news/studies/2011/913studyfinal.pdf.

Commission's most significant rulemaking to date tied primarily to authority granted to the Commission by Section 211(h).[10]

Reading Section 211(h) to authorize plenary rulemaking over private fund advisers would be inconsistent with more than 80 years of U.S. regulation of the investment management industry. The Investment Company Act of 1940 ("Company Act") and the Advisers Act were enacted at the same time and could not be more different – the Company Act imposes detailed reporting, conduct and governance requirements over registered investment companies, while the Advisers Act establishes a disclosure-based regime premised on antifraud concerns applicable to advisers' dealings with all of their clients. The Supreme Court confirmed in *SEC v. Capital Gains Research Bureau , Inc.* that the "evident purpose" of the Advisers Act, enacted in 1940, "to substitute a philosophy of disclosure for the philosophy of caveat emptor",[11] and the Court further noted that the Advisers Act "reflects a . . . congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested".[12] The ' Fiduciary Interpretation addresses conflicts of interest in a manner consistent with the Advisers Act's philosophy of disclosure, and made it plain that the nature of the fiduciary relationship between adviser and client can be shaped by the sophistication of the client or investors.

The Proposed Rules are inconsistent with the differential status of private funds under applicable law. Congress passed the National Securities Markets Improvement Act in 1996,[13] which added the section 3(c)(7) exclusion[14] ("Section 3(c)(7)")[15] from the definition of "investment company" for larger private funds "premised on the theory that 'qualified purchasers' [who were the only persons allowed to invest in such funds] do not need the [Company Act's] protections because they are able to monitor for themselves such matters as management fees, transactions with affiliates, corporate governance, and leverage".[16] That exemption was provided at the urging of the Commission itself,[17] and reflects a clear and unmistakable Congressional intention,

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[10] Form CRS Relationship Summary; Amendments to Form ADV, SEC Release No. IA-5247 at 511 (noting that Rule 204-5, which requires delivery of Form CRS, was promulgated partly in reliance upon Section 211(h)).

[11] *SEC v. Capital Gains Research Bureau, Inc.*, 275 U.S. 180, 186 (1963).

[12] *Id*. at 191-92.

[13] National Securities Markets Improvements Act of 1996, Pub. L 104-290 (1996).

[14] *Id.* at § 209(a)(4).

[15] Investment Company Act of 1940 § 3(c)(7).

[16] Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, U.S. Securities and Exchange Commission (May 1992) at 104-5 (emphasis added).

[17] *Id.*

particularly supported by the legislative history of Section 3(c)(7), that funds comprised of highly sophisticated investors should not be subjected to the comprehensive regulatory rigors of statutes such as the Company Act. The Commission, however, now proposes rules that would impose exactly the sort of regulatory regime that Congress purposely eschewed. The Proposed Rules would subject private funds, whose investors are among the most sophisticated in the world, to some provisions that are more restrictive than those under which funds designed for retail investors and other investment advisory services provided to retail clients operate. This is contrary to Congressional intent, as well as decades of precedent whereby the Commission has recognized that private fund investors have the sophistication to transact freely without imposing as many restrictions as is appropriate for retail investors.

Similarly, the Commission should provide an explanation of its authority under Section 206(4) of the Advisers Act ("Section 206(4)") to issue several of the Proposed Rules, including but not limited to the Prohibited Activities Rule. Section 206(4) is an antifraud statute that makes it unlawful for any investment adviser to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative". This provision sounds in deception. Yet the Commission expressly rejects any requirement of deception, specifying that consent of the investors is irrelevant. Addressing the Prohibited Conduct Proposal, the Proposing Release states that[18]

> 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 . . . .

The Commission provides no explanation as to how an antifraud statute can provide authority to promulgate rules that prohibit conduct where there is informed consent. One can only imagine that such rules would only make sense where the investors are viewed as incapable of giving informed consent, but the investors at issue in the Proposed Rules are sophisticated by definition.

In the Proposing Release, the Commission asked commenters for input on whether there are alternative approaches that it should require to improve investor protection and bring greater efficiency to the market, including the following questions:[19]

> 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 impose limitations on

[18] Proposing Release at 132-33.

[19] Proposing Release at 23.

> 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?

The Commission has not adequately explained the basis for authority to regulate the amount of fees and compensation that investment advisers can charge their clients. Fee and compensation amounts are established by contract, a principle reflected in the Advisers Act. The only section of the Advisers Act limiting the fees that an investment adviser may charge is section 205(a)(1) ("Section 205(a)(1)"),[20] which prohibits a registered investment adviser from entering into a contract providing for "compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciated of the funds or any portion of the funds of a client". Not only does Section 205(a)(1) expressly exempt funds relying on Section 3(c)(7) from its requirements,[21] it limits the SEC's rulemaking authority to exempting from its requirements "any person that the Commission determines does not need the protections of subsection (a)(1)"[22] and provides that such exemptions may be "on the basis of such factors as financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the Commission determines are consistent with this section". The Commission should explain what authority it currently has under the Advisers Act to set maximum fees or prohibit specific compensation arrangements.

B. Applying the Prohibited Activities Proposal and the Preferential Treatment Proposal to Non-Registered Investment Advisers Is Inconsistent with Congressional Intent in Establishing Exemptions from Registration.

If adopted as currently proposed, the Prohibited Activities Proposal and Preferential Treatment Proposals would apply to all investment advisers, whether registered with the Commission or not. We believe that subjecting non-registered investment advisers ("Non-RIAs") to the same level of substantive restrictions as registered investment advisers ("RIAs") is contrary to Congress' intention in the Dodd-Frank Act of creating a less burdensome regulatory regime for investment advisers whose activities are so limited so as to qualify for an exemption from registration. By statute, the only requirements applicable to exempt reporting

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[20] Advisers Act § 205(a)(1).

[21] Advisers Act § 205(b)(4).

[22] *See* Advisers Act § 205(e).

advisers ("ERAs") are (i) reporting on an abbreviated version of Form ADV, (ii) compliance with section 206 of the Advisers Act, including Advisers Act Rule 206(4)-8, (iii) the requirement under section 204A of the Advisers Act to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information in violation of the Advisers Act or the Exchange Act (or applicable rules thereunder) and (iv) compliance with Advisers Act Rule 206(4)-5.

We note, in particular, that although ERAs are subject to the fiduciary duties that arise under the Advisers Act and the requirements identified above, "[e]xempt reporting advisers are required to file with the Commission certain information required by Form ADV, but are not subject to many of the other substantive requirements to which registered investment advisers are subject".[23] Statements by Commissioners relatively contemporaneous to Dodd-Frank regarding the then-newly promulgated exemptions from registration highlighted that ERA status would require reporting,[24] and Chair Mary Schapiro noted that, in developing the reporting requirements for ERAs, the Commission followed "a balancing approach", requiring information on key census data about the firm, but not the "the full panoply of information, including the ADV, Part 2 client-oriented narrative disclosure that would be required of a registered investment adviser".[25] We believe that this statement evinces a Commission view, based on clear Congressional intent, that regulation of Non-RIAs should generally be less burdensome relative to that of RIAs.

The application of the Prohibited Activities Proposal and the Preferential Treatment Proposal to Non-RIAs would impose significant burdens on such advisers to an extent that fundamentally alters their regulatory status. Firms that structured their organizations in a manner to remain consistent with exemptions from registration would be required to make key changes to contract terms and expense provisions, as well as disrupt settled economic arrangements with clients

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[23] SEC Release No. Ia-5454 (March 2, 2020).

[24] *See,* Chair Mary Schapiro, Opening Statement at SEC Open Meeting: Dodd-Frank Act Amendments to the Investment Advisers Act, (June 22, 2011), available at https://www.sec.gov/news/speech/2011/spch062211mls-items-1-2.htm ("While the Dodd-Frank Act imposes new registration responsibilities upon advisers to hedge funds and many other private funds, Congress exempted from registration advisers solely to venture capital funds and advisers solely to private funds with less than $150 million in assets in the United States. But, at the same time, Congress mandated that these advisers be subject to certain reporting requirements".); Commissioner Luis A. Aguilar, "Implementing Dodd-Frank: The Changing Investment Adviser Regulatory Landscape", Nov. 19, 2010, available at https://www.sec.gov/news/speech/2010/spch111910laa-items1-2.htm ("[Dodd-Frank:] Requires investment advisers to private funds to register with the Commission, while exempting others; and; Requires reporting and record-keeping by advisers that are exempt from registration.)

[25]Opening Statement at SEC Open Meeting: Dodd-Frank Act Amendments to the Investment Advisers Act, (June 22, 2011) https://www.sec.gov/news/speech/2011/spch062211mls-items-1-2.htm

and investors, which is inconsistent with the approach adopted by Congress in Dodd-Frank.

Imposing the burdens of the Prohibited Activities Rule and the Preferential Treatment Rule to Non-RIAs is especially concerning when one considers that many ERAs and other Non-RIAs have their principal office and place of business outside the United States. In 2011, the Commission adopted rules regarding ERAs and foreign private advisers, and it noted in the adopting release accompanying such rules that one of the goals of such exemptions was "to encourage the participation of non-U.S. advisers in the U.S. market by applying U.S. laws in a manner that does not impose U.S. regulatory and operational requirements on a non-U.S. adviser's non-U.S. advisory business" and does so "in keeping with general principles of international comity".[26] The Commission stated that non-U.S. advisers relying on Rule 203(m)-1 would "remain subject to the Advisers Act's antifraud provisions and will become subject to the requirements applicable to exempt reporting advisers".[27] The application of the broader Proposed Rules to this category of ERAs would contradict that original intent of applying a less extensive set of rules to ERAs, including the international comity and extraterritoriality concerns articulated by the Commission. To the extent that the Preferential Treatment Proposal and Prohibited Activities Proposal are adopted (in any form), we believe that it would be inappropriate to apply such proposals to Non-RIAs.

II. The Proposed Rules are Inconsistent with the Fiduciary Interpretation and the Advisers Act's Disclosure-Based Approach to Regulation of Investment Advisers.

A. The Proposed Rules are Inconsistent with the Fiduciary Interpretation.

The Proposed Rules, in particular the Prohibited Activities Proposal, the Adviser-Led Secondaries Proposal and the Preferential Treatment proposal, depart dramatically from the Commission's longstanding approach under the Advisers Act towards conflicts of interest, which has typically avoided flat prohibitions or restrictions in favor of meaningful disclosure and informed consent.

In 2019, the Commission reaffirmed its historic approach with the Fiduciary Interpretation, which interpreted the standard of conduct for investment advisers under the Advisers Act. The Commission confirmed that under the Advisers Act, investment advisers are subject to fiduciary duties comprised of the

[26] Page 96 of the SEC Release No. 3222 (June 22, 2011); See also N. 207 of SEC Release No. 31111 (Nov. 19, 2010).

[27] Page 96 of the SEC Release No. 3222 (June 22, 2011).

duty of care and duty of loyalty. The Commission explained, "Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund and its investors, and includes an obligation to provide 'full and fair disclosure of all material facts' to investors and independent trustees of the fund".

In the Fiduciary Interpretation, the Commission noted that some commenters had expressed a desire for the Commission to adopt rules to clarify application of those duties.[28] The Commission indicated in response that it saw no need for such rules.[29] As the Commission said:

> [T]he relationship between an investment adviser and its client has long been based on fiduciary principles not generally set forth in specific statute or rule text. We believe that this principles-based approach should continue as it expresses broadly the standard to which investment advisers are held while allowing them flexibility to meet that standard in the context of their specific services. In our view, adopting rule text is not necessary to achieve our goal in this Final Interpretation of reaffirming and in some cases clarifying certain aspects of the fiduciary duty.

In short, the Commission acknowledged that the standard of care differs depending on facts and circumstances, and that explicit prohibitions stating what is or is not permitted under that standard of care would not be helpful for an industry in which participants vary widely.

The Fiduciary Interpretation restated, with respect to conflicts of interest, the Commission's belief that "an adviser must eliminate *or at least expose through full and fair disclosure* all conflicts of interest which might incline an investment adviser—consciously unconsciously—to render advice that was not disinterested".[30] (Emphasis added). Whether full and fair disclosure has been made, and whether the client has provided informed consent, depends on facts and circumstances surrounding that relationship – for example, the level of sophistication of the adviser's clients. The Fiduciary Interpretation acknowledged that investment advisers serve a large variety of clients, from retail clients with limited assets and investment knowledge and experience, to institutional clients with large portfolios and substantial knowledge, experience and analytical resources. In light of these different circumstances, the fiduciary duty "must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client".[31] Seen through the lens of the agency

[28] Fiduciary Interpretation at 5 ("[s]ome commenters requested that we adopt rule text instead").

[29] *Id.*

[30] *Id.* at 6.

[31] *Id.* at 9-10.

relationship between an adviser and its client, "when a principal consents to specific transactions or to specified types of conduct by the agent, the principal has a focused opportunity to assess risks that are more readily identifiable".[32] Prohibiting specific transactions is not necessary when full and fair disclosure, and informed consent, are possible.

The Fiduciary Interpretation recognized that when an investment adviser cannot fully and fairly disclose a conflict of interest such that the client can provide informed consent, the adviser should either eliminate the conflict or adequately mitigate it.[33] The prohibitions in the Proposed Rule, however, address conflicts with respect to which the investment adviser can make full and fair disclosure and obtain informed consent, and the Commission has provided no evidence to the contrary. For example, if an adviser provides preferential liquidity to a seed investor, it can explain to other investors the potential consequences of that term such that the investors can determine whether the risk is acceptable or whether they should forgo the investment. While there may be unsophisticated investors for which no amount of disclosure would be adequate, the Proposed Rule fails to differentiate between unsophisticated and sophisticated investors and rather establishes a blanket prohibition of certain transactions and preferential terms with no evidence to support such broad prohibitions.

The Commission states in the Proposing Release that it believes that the activities prohibited by the Proposed Rules "incentivize advisers to place their interests ahead of their clients' (and by extension, their investors') and can result in private funds and their investors, particularly smaller investors that are not able to negotiate preferential deals with the adviser and its related persons, bearing an unfair proportion of fees and expenses".[34] However, the Proposed Rules do not distinguish between sophisticated investors and retail investors. This directly contradicts the position taken by the Commission in the Fiduciary Interpretation, which recognized that the level of protection required for a sophisticated investor is less than that required for retail clients of an investment adviser.

The Commission has offered insufficient support for the Proposed Rules in the form of statistics, administrative actions or case law to justify the broad changes that would be effected by the Proposed Rules. As discussed above, fewer than three years ago, the Commission reaffirmed and clarified its approach to investment advisers' standard of care for the first time since the enactment of the Advisers Act in 1940. In doing so, it recognized that "the interpretations set forth in this Final Interpretation are generally consistent with investment advisers' current understanding of their fiduciary duty under the Advisers Act". This

[32] *Id.* at 10 n. 29 (citing Restatement (Third) of Agency, § 8.06 Principal's Consent (2006)).

[33] *Id.* at 6.

[34] Proposing Release at 132.

understanding has been generally accepted within the industry and relied on for decades by investment advisers in structuring funds and entering into agreements with investors. The Proposed Rules represent a significant change from existing laws and practices, and compliance with the rules is likely to result in significant costs for many investment advisers as they attempt to conform existing funds to the new requirements. There is no indication as to what changed in the intervening three years since the Fiduciary Interpretation. Even looking back to Dodd-Frank, the Commission cites unspecified "observations" and 24 enforcement actions against advisers to private funds.[35] That there have been only 24 such actions over ten years with more than 5,000 advisers[36] with more than 37,000 private funds[37] does not support a conclusion that there is widespread noncompliance requiring sweeping changes. As a matter of administrative law, there should be compelling reasons to change such a recently reaffirmed standard. The Proposed Rule Release relies primarily on a Vanderbilt Law Review article focused entirely on the private equity industry.[38] If the Commission is to adopt such a radically different approach to conflicts of interest that applies broadly to all private fund managers, there should be compelling evidence for doing so.[39]

In keeping with the Commission's historical approach and the Fiduciary Interpretation, we believe that the Proposed Rule should not include blanket prohibitions on common industry practices but rather should continue to rely instead on full and fair disclosure of such practices, and informed consent.

B. The Commission Should Not Adopt Rule 211(h)(2)-1(a)(5) as Proposed.

One element of the Prohibited Activities Proposal is a prohibition on an investment adviser to a private fund from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or

[35] *See generally* Proposing Release.

[36] Proposing Release at 8.

[37] See Division of Investment Management: Analytics Office, Private Funds Statistics Report: First Calendar Quarter 2021 (Nov. 1, 2021) ("Form PF Statistics Report"), at 31, available at https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2021-q1.pdf.

[38] Proposing Release at 132 n. 146. We note that the Proposing Release appears to cite a draft of this article, and the final version appears to have been published on April 21, 2022, four days prior to the end of the comment period. *See* Clayton, William, *High-End Bargaining Problems*, 75 Vand. L. Rev 703 (2022), *available at* https://vanderbiltlawreview.org/lawreview/2022/04/high-end-bargaining-problems/ (noting on the website that it was posted on April 21, 2022).

[39] In 2006, the United States Court of Appeals for the District of Columbia Circuit vacated a rule adopted by the Commission that would have treated hedge fund investors as "clients" of the funds' investment advisers for purposes of the Advisers Act. See Goldstein v. SEC, , 451 F.3d 873 (D.C. Cir. 2006). Among the reasons cited by the Court for its decision was that the Commission had not adequately justified departing from its long-standing position on the issue, saying "[t]he Hedge Fund Rule might be more understandable if, over the years, the advisory relationship between hedge fund advisers and investors had changed. . . . But without any evidence that the role of fund advisers with respect to investors had undergone a transformation, there is a disconnect between the factors the Commission cited and the rule it promulgated". *Id.* at 882.

the private fund's investors for a breach of its fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.[40] As noted in the Proposing Release, rule 211(h)(2)-1(a)(5) ("Prohibited Activities Proposal (a)(5)") would apply to all private fund advisers, not just those investment advisers to private funds that are registered with the Commission.[41] We recommend that the Commission not adopt Prohibited Activities Proposal (a)(5), and instead, rely on the guidance in the Fiduciary Interpretation. We recommend in the alternative that the Commission (a) limit Prohibited Activities Proposal (a)(5) to RIAs, and then only with respect to services that are investment advisory services, and (b) permit reimbursement, indemnification, exculpation and limitation of liability at least to the extent permitted an investment adviser to a registered investment company under section 17(i) of the Company Act.[42]

We support the position long held by the Commission and its staff (the "Staff") that, depending on the relevant facts and circumstances, a clause or statement that purports to limit the investment adviser's liability to a client (commonly referred to as a "hedge clause") could be misleading, and thus, a violation of section 206(1) or section 206(2) of the Advisers Act.[43] Although the relationship of an investment adviser to its client under the Advisers Act is one of a fiduciary, the Advisers Act does not impose a specific standard of care on investment advisers generally, much less a standard specific to investment advisers to private funds.[44] Instead, the Advisers Act contemplates that that standard should be a product, at least in part, of the agreement of the investment adviser and its client. As noted in the 2019 Fiduciary Interpretation, "[a]lthough all investment advisers owe their clients a fiduciary duty, that fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship between the adviser and client".[45]

Prohibited Activities Proposal (a)(5), if adopted as proposed, would take the opposite approach to that taken in the Fiduciary Interpretation and historically by the Staff. By specifically identifying certain types of prohibited activities,

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[40] Proposed rule 211(h)(2)-1(a)(5).

[41] Proposing Release at 133.

[42] Company Act § 17(i) provides in relevant part that "no contract or agreement under which any person undertakes to act as an investment adviser of . . . a registered investment company shall contain any provision which protects or purports to protect such person against any liability to such company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract or agreement".

[43] See, e.g., "Opinion of the General Counsel relating to the use of 'hedge clauses' by brokers, dealers, investment advisers, and others", SEC Release No. IA-58 (April 10, 1951); Fiduciary Interpretation at notes 31 and accompanying text; EXAMS Alert at III.D.

[44] Investment advisers are required to act as fiduciaries with respect to their clients, however no contractual standard of care is specified.

[45] Fiduciary Interpretation, at 9-10.

Prohibited Activities Proposal (a)(5) would as a practical matter establish a specific minimum standard of care on investment advisers to all types of private funds. That result, in addition to being inconsistent with the Fiduciary Interpretation, likely would be detrimental to investors who choose to invest in securities through private funds, especially when it exposes the investment adviser to greater liability than what may be otherwise acceptable to private fund investors. We believe that imposing a minimum standard would, among other things, discourage the formation of new investment advisers to private funds, as well as small investment advisers from offering new private funds, and investment advisers offering through private funds innovative investment strategies or strategies using new types of financial instruments, especially when those strategies and instruments come with significant risks in addition to significant potentials for profit.[46]

The Commission supports Prohibited Activities Proposal (a)(5) by citing, among other things, that investment advisers have over time included in private fund documents more aggressive liability waiver and indemnification provisions, including provisions the Commission believes are inconsistent with section 206(1) and section 206(2) of the Advisers Act and thus, invalid pursuant to section 215 of the Advisers Act.[47] Moreover, the Commission argues that some private fund investors may not recognize when certain provisions are too aggressive or the importance of various rights investors are being asked to waive.[48] We are not disputing the Commission's finding that some waiver and indemnification provisions in some private fund agreements could be deemed to be in violation of sections 206(1) and section 206(2) of the Advisers Act. We are not disputing the Commission's position that some private fund investors may not recognize when certain waiver and indemnification provisions are invalid. However, the Commission and the Staff have recently issued guidance regarding when certain waiver and indemnification provisions go too far.[49] What the Proposing Release does not explain, however, is why a rule specifying a specific minimum standard, and prohibiting a commonly-accepted limitation on liability

[46] For example, various members of the Subcommittee have reported that insurance brokers are advising new or small investment advisers that their cost of purchasing errors and omissions liability coverage would increase substantially if proposed Advisers Act Rule 211(h)(2)-1(a)(5) were adopted as proposed.

[47] Proposing Release at n. 170-173 and accompanying text.

[48] *Id.* At note 170 (citing P. Molk, "Protecting LLC Owners While Preserving LLC Flexibility", 51 U.C. Davis Law Rev. (2018), 2129, 2133).

[49] *See, e.g.,* Fiduciary Interpretation, at notes 30-31 and accompany text; EXAMS Alert, at III.D.

to gross negligence, is necessary in light of such guidance.[50] As noted elsewhere in this letter, private funds are generally intended for sophisticated investors. However, less sophisticated investors or investors uncomfortable with the terms offered by private funds have an alternative: mutual funds and other registered investment companies. The Company Act, which applies to all registered investment companies, expressly limits an investment company's risks and trading strategies, requires independent director oversight, and expressly limits the ability of an investment adviser to seek redress in the event of certain prohibited activities.

The Commission cites academic papers claiming that a common standard would reduce the cost, time and complexity of negotiating the terms of investment, and it would prevent certain investors, primarily larger or more influential investors, from possibly benefiting from a more investor-friendly standard than smaller or less influential investors.[51] We agree that a common standard would reduce negotiation costs, to the extent that it is actively negotiated. What the Commission does not address, however, is what opportunities may be lost if that standard imposes more costs or risks on the investment adviser than the investment adviser may be willing to assume. We recognize that larger or more influential investors typically invest in private funds on terms that are more beneficial to them than smaller or less influential investors. However, the Commission does not explain how that result, in the case of a common liability standard, may disadvantage smaller or less influential investors investing in the same private funds.[52]

If the Commission is intent on adopting Prohibited Activities Proposal (a)(5) notwithstanding its potential adverse effects on the market for private funds, we propose certain changes to the proposal.

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[50] In the Commission's press release announcing the Proposing Release, Commissioner Hester Pierce is quoted as stating "Today's proposal represents a sea change. It embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationships with private funds". "SEC Proposed to Enhance Private Fund Investor Protection", SEC Press Release 2022-19 (February 9, 2022) available at https://www.sec.gov/news/press-release/2022-19 . The Commission cites as support for a similar argument in the Proposing Release an academic paper that is currently unpublished, and thus, not available to commenters. Proposing Release at note 146 and accompanying text. Without having access to the information available to the Commission, we are not in a position to agree or disagree with the Commission's assertion, and thus, we have not addressed that assertion in this comment letter.

[51] *See* Proposing Release at 132 n. 146.

[52] If certain investors in a private fund negotiate a higher standard of liability, and that higher standard is intended to cause the investment adviser to manage the private fund's investments in a manner more favorable to the private fund's investors, presumably all investors in the private fund would benefit, even if the investment adviser's agreement to commit to the higher standard is provided only to certain investors and not all. In that case, the only issue is which investors may enforce the higher standard, and on that issue, the interests of the investors that negotiated the higher standard would seemingly be aligned with the interests of all other investors.

First, we propose that Prohibited Activities Proposal (a)(5) only apply to those investment advisers registered with the Commission, and not to other types of investment advisers, such as state-registered investment advisers, exempt-reporting advisers or investment advisers otherwise exempt from having to register with the Commission. Congress determined in passing the Dodd-Frank Act that certain types of investment advisers, including ERAs, should not be subject to all of the burdens that the Advisers Act imposes on registered investment advisers. We believe that the costs and implications of Prohibited Activities Proposal (a)(5) as proposed would be unnecessarily burdensome on these types of investment advisers.

Second, we recommend that the limitation on the services covered by Prohibited Activities Proposal (a)(5) only apply to investment advisory services provided by the investment adviser. Other services, such as property management services provided to portfolio investments held by a real estate private equity fund, which do not involve a fiduciary relationship, should not be subject to the same liability standards, especially if those services are clearly delineated as separate from the investment advisory services provided by the investment adviser.

Third, Prohibited Activities Proposal (a)(5) should permit reimbursement, indemnification, exculpation and limitation of liability at least to the extent permitted an investment adviser to a registered investment company under section 17(i) of the Company Act. Specifically, this would permit investment advisers to private funds from receiving compensation for claims involving negligence other than claims of gross negligence. As registered investment companies are intended to be offered to retail investors, presumably, a standard of liability determined by Congress to be suitable for registered investment companies (and the retail investors they are designed to serve) should at least be a suitable standard for private funds whose investors are presumed to be sophisticated. Moreover, in our experience, the gross negligence standard is generally accepted by institutional investors[53] and, in the absence of limitations of liability for ordinary negligence, private fund managers would be less likely to undertake novel strategies and investments, thus reducing innovation and limiting the universe of investment opportunities available to investors.

III. <u>The Application of the Proposed Rules to Existing Arrangements Should be Grandfathered.</u>

A number of the provisions of the Private Fund Rules would apply to and prohibit certain aspects of existing contractual arrangements. We believe that

[53] *See, e.g.,* Institutional Limited Partners Association, "Model Limited Partnership Agreement", Section 1, definition of "Exculpation Exclusion Event", available at https://ilpa.org/wp-content/uploads/2020/07/ILPA-Model-Limited-Partnership-Agreement-WOF.pdf .

applying the Private Fund Rules to the thousands of existing contractual arrangements would not meet the judicial standards for retroactive rulemaking and would be a departure from the approach the Commission has taken in the past with respect to rules that may affect existing contractual arrangements. Notable examples of such an approach were the Advisers Act's performance fee prohibition and its venture capital definition, as detailed further below.

As proposed, the Prohibited Activities Proposal would prohibit certain provisions in existing contractual agreements between the private fund adviser and the private fund, including (i) agreements under which fund investors specify that the private fund adviser (or an affiliate) may receive accelerated monitoring fees or other payments for "unperformed" services; (ii) "pass through" expense models or other agreements under which fund investors pay certain regulatory or compliance expenses; (iii) agreements under which fund investors permit the adviser (and its related persons) to clawback performance-based compensation on an after-tax basis; (iv) agreements under which a private fund adviser provides for reimbursement, indemnification, exculpation, or limitation of liability based on a standard different from that contemplated by the Prohibited Activities Proposal; (v) agreements under which fund investors specify that the fund may bear a non-pro rata share of the expenses associated with a particular investment; and (vi) agreements that permit the adviser (or its related persons) to engage in borrowing from the private fund under limited circumstances.

The Preferential Treatment Proposal, in addition to the prohibitions outlined above, would prohibit existing side letter or other agreements under which a private fund adviser provides redemption or information rights that may have a material, negative effect on other investors. The Preferential Treatment Proposal may also prevent other existing preferential treatment under which a private fund sponsor did not provide an advance written notice meeting the standard of the Preferential Treatment Proposal.

Applying these restrictions to existing contractual agreements would be retroactive rulemaking on thousands of private fund agreements, particularly when considering the Commission is proposing to apply the Prohibited Activities Proposal and Preferential Treatment Proposal to both registered and unregistered investment advisers. The Commission repeatedly notes that the Private Fund Rules are intended to affect the balance of negotiations between private fund advisers and investors.[54] The Commission also notes that these Private Fund Rules are likely to affect future agreements.[55] In short, the Commission is acknowledging that it is re-writing the existing contractual bargains between private fund advisers and their investors, notwithstanding that many of the concerns outlined in the Private Funds Proposing Release are equally present in relationships between RIAs and their retail clients who are likely to be in a position of having far less bargaining power relative to their advisers than wealthy, sophisticated private fund investors. Yet, aside from regulating the ability of RIAs to charge performance-based compensation under Advisers Act Rule 205-3, the Commission appears not to have, in the past, used its rulemaking authority to impose substantive restrictions on the ability of RIAs and their retail clients to freely negotiate and agree to contractual terms. The Commission has provided no explanation as to why disclosure and consent based on traditional fiduciary principles continues to be sufficient protection for retail clients in contract negotiations but is no longer sufficient for sophisticated private fund investors.

As recognized by the Supreme Court, "the presumption against retroactive legislation is deeply rooted in our jurisprudence".[56] "Elementary considerations of fairness, the Court has said, "dictate that individuals should have an opportunity to know what the law is and to conform their conduct accordingly; settled expectations should not be lightly disrupted".[57] These concerns are amplified with respect to legislation that affects existing contractual agreements—"[i]n a free, dynamic society, creativity in both commercial and

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[54] *See*, *e.g.*, Private Funds Proposing Release at 19 (expressing a hope that "the investor may be in a better position to negotiate lower fee rates for future investments because the investor would be aware of the rates charged by certain advisers in that segment of the market"); 132 (expressing concern for "smaller investors that are not able to negotiate preferential deals with the adviser and its related persons"); 151 & fn. 173 (expressing concern "where investors with less bargaining power are forced to bear the brunt of such arrangements"); 194 (expressing concern for investors that "are not able to negotiate or directly discuss the terms of the borrowing with the adviser"); 195 (expressing concern that "some investors may find it relatively difficult to negotiate agreements that would fully protect them from bearing unexpected portions of fees and expenses or from other decreases in the value of investments associated with the above-described practices"); 196 (expressing concern that due to a "lack of transparency" on preferential treatment "investors may simply be unaware of the types of contractual terms that could be negotiated"); 217 (stating that disclosure may not be sufficient because "many of these conflicts of interest and sources of harm may be difficult for investors to detect or negotiate terms over"); 221 (noting one of the goals of the rules is to "improve the ability of investors to negotiate terms related to the governance of the fund"); 222 (stating that "[i]nvestors may also have an improved ability to negotiate expenses and other arrangements in any subsequent private funds raised by the same adviser").

[55] *See*, *e.g.*, Private Funds Proposing Release at 236 (noting that adviser may negotiate a "a new fixed management fee to compensate for the new costs"); 238 – 239 (noting that advisers may "re-negotiate, re-structure and/or revise certain existing deals or existing economic arrangements in response to" the Private Fund Rules); 241 (same); 243 (same); 247 (same); 248 (same).

[56] Landgraf v. USI Film Prods., 511 U.S. 244, 265.

[57] *Id.* at 265. *See also* General Motors Corp. v. Romein, 503 U.S. 181, 191, 112 S.Ct. 1105, 1112, 117 L.Ed.2d 328 (1992) ("Retroactive legislation presents problems of unfairness that are more serious than those posed by prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions").

artistic endeavors is fostered by a rule of law that gives people confidence about the legal consequences of their actions".[58] As the Court has said: "[t]he largest category of cases in which we have applied the presumption against statutory retroactivity has involved new provisions affecting contractual or property rights, matters in which predictability and stability are of prime importance".[59] In this regard, the Court has expressed concern for retroactive legislation that is intended to favor one party over another party, particularly politically "unpopular" groups.[60]

The courts, including the Supreme Court, have applied the presumption against retroactive measures with respect to administrative rulemaking. According to the Supreme Court, "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".[61] The Supreme Court has said further said that "[e]ven where some substantial justification for retroactive rulemaking is presented, courts should be reluctant to find such authority absent an express statutory grant".[62] The D.C. Circuit has adopted a five factor test to determine when retroactive application should be permitted including: "(1) whether the particular case is one of first impression, (2) whether the new rule represents an abrupt departure from well-established practice or merely attempts to fill a void in an unsettled area of law, (3) the extent to which the party against whom the new rule is applied relied on the former rule, (4) the degree of the burden which a retroactive order imposes

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[58] Landgraf v. USI Film Prods., 511 U.S. 244, 265 – 266.

[59] *Id.* at 271 (citing United States v. Security Industrial Bank, 459 U.S. 70, 79–82, 103 S.Ct. 407, 413–414, 74 L.Ed.2d 235 (1982); Claridge Apartments Co. v. Commissioner, 323 U.S. 141, 164, 65 S.Ct. 172, 185, 89 L.Ed. 139 (1944); United States v. St. Louis, S.F. & T.R. Co., 270 U.S. 1, 3, 46 S.Ct. 182, 183, 70 L.Ed. 435 (1926); Holt v. Henley, 232 U.S. 637, 639, 34 S.Ct. 459, 460, 58 L.Ed. 767 (1914); Union Pacific R. Co. v. Laramie Stock Yards Co., 231 U.S., at 199, 34 S.Ct., at 102; Twenty Per Cent Cases, 20 Wall. 179, 187, 22 L.Ed. 339 (1874); Sohn v. Waterson, 17 Wall. 596, 599, 21 L.Ed. 737 (1873); Carroll v. Lessee of Carroll, 16 How. 275, 14 L.Ed. 936 (1854)).

[60] *See* Landgraf v. USI Film Prods., 511 U.S. 244, 266 ("Its responsivity to political pressures poses a risk that it may be tempted to use retroactive legislation as a means of retribution against unpopular groups or individuals".). *See also id.* at fn. 20 ("James Madison argued that retroactive legislation also offered special opportunities for the powerful to obtain special and improper legislative benefits. According to Madison, '[b]ills of attainder, ex post facto laws, and laws impairing the obligation of contracts' were 'contrary to the first principles of the social compact, and to every principle of sound legislation,' in part because such measures invited the 'influential' to 'speculat[e] on public measures,' to the detriment of the 'more industrious and less informed part of the community.' The Federalist No. 44, p. 301 (J. Cooke ed. 1961)).

[61] Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208–09, 109 S. Ct. 468, 471–72, 102 L. Ed. 2d 493 (1988).

[62] *Id.*

on a party, and (5) the statutory interest in applying a new rule despite the reliance of a party on the old standard".[63]

None of the standards or conditions identified as supporting retroactive application has been met with respect to the Private Fund Rules. The Commission has not adequately explained the basis for its authority under Section 206(4) or 211(h) to promulgate retroactive rulemaking. The Private Fund Rules would affect the contractual agreements of private parties, many of which have been negotiated and agreed upon many years ago. The Commission recently considered whether to prohibit certain conflicted activities, declined to do so, and instead decided to rely on full and fair disclosure and informed consent, particularly for institutional clients.[64] The Private Fund Rules represent an "abrupt departure from well-established practice" under which the Commission has addressed conflicts of interest using a principles-based approach.[65] Thousands of private fund advisers have relied on this principles-based approach with respect to thousands of agreements with respect to private funds and investors. The Commission has presented no economic or other justification for why retroactive application is necessary or appropriate or why it outweighs the negative consequences of doing so.

Seemingly in recognition of the unfairness of retroactive application of a rule, the Commission has historically provided grandfathering and other transition provisions to avoid affecting existing contractual agreements between investment advisers and clients or investors. For example, the Commission adopted the transition rules under Advisers Act Rule 205-3 to allow a newly-registered investment adviser to continue to charge performance fees to existing clients and investors who are not "qualified clients".[66] These transition rules were adopted in order to avoid "disrupting existing arrangements".[67]

Another example of grandfathering in the context of the Advisers Act occurred with respect to the adoption of the implementing Rule 203(l)-1 for the venture capital fund adviser exemption in Section 203(l) of the Advisers Act. In that case, the Commission adopted a grandfathering provision for existing

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[63] *See* Cassell v. F.C.C., 154 F.3d 478, fn. 6 (D.C. Cir. 1998) (Referring to them as the Clark-Cowlitz factors), *citing* Clark-Cowlitz Joint Operating Agency v. F.E.R.C., 826 F.2d 1074, 1081 (D.C. Cir. 1987), *cert. denied*, 485 U.S. 913, 108 S. Ct. 1088, 99 L. Ed. 2d 247 (1988).

[64] *See* Fiduciary Interpretation at n. 31 (declining to restrict use of hedge clauses) and at fn. 70 (noting that "institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications").

[65] *See* Fiduciary Interpretation at 5 ("We believe that this principles-based approach should continue as it expresses broadly the standard to which investment advisers are held while allowing them flexibility to meet that standard in the context of their specific services".)

[66] Advisers Act Rule 205-3(c)(2).

[67] Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333 (Dec. 2, 2004) at the paragraph accompanying fns. 259 – 264.

venture capital funds that did not meet the new definition of "venture capital fund" in Rule 203(l)-1.[68] The Commission decided to adopt this grandfathering provision because it determined that "requiring existing venture capital funds to modify their investment conditions or characteristics, liquidate portfolio company holdings or alter the rights of investors in the funds in order to satisfy the definition of a venture capital fund would likely be impossible in many cases and yield unintended consequences for the funds and their investors".[69]

IV. Suggestions Relating to Certain Aspects of the Proposed Rules.

A. Requiring Disclosure and Informed Consent to Conflicts of Interest is More Consistent with Congressional Intent and the Structure of the Advisers Act.

As we have maintained in the above sections, certain aspects of the Proposed Rules are inconsistent with Congressional intent, the structure of the Advisers Act, and the Fiduciary Interpretation. The Prohibited Activities Proposal, the Advisor-Led Secondaries Proposal, and the Preferential Treatment Proposal each aims to address conflicts of interest. Rather than impose prohibitions with respect to which the Commission's authority is suspect, the better approach for addressing such conflicts of interest is the one established by the Commission in 2019 through the Fiduciary Interpretation – full and fair disclosure and informed consent.

Each of the activities contemplated by the Prohibited Activities Proposal would be better addressed through disclosure and informed consent. Sophisticated investors are in a position to understand the effect of fees and expenses, particularly in light of proposed additional disclosures relating to such costs, and are able to provide consent relating to such matters. Sophisticated investors can understand fees charged to portfolio investments and the fees and expenses associated with regulatory or compliance activities, examinations, and investigations relating to the adviser or related persons. Similarly, private fund investors have the sophistication and resources to understand the impact of the reductions in clawback amounts for actual, potential, or hypothetical taxes applicable to an adviser, its related persons, or their respective owners or interest holders, as well as the effect of terms pertaining to limitations on liability, indemnification, reimbursement, and exculpation, as well as the effects of non-pro rata allocation of investment expenses or loans of assets. To the extent that the Commission believes that existing protections for private fund investors are

[68] Advisers Act Rule 203(l)-1(b).

[69] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3222 (Jun. 22, 2011) at sentence accompanying fn. 311. See also id at n. 311 ("We believe that the grandfathering provision will promote efficiency because it will allow advisers to existing venture capital funds to continue to rely on the exemption without having to restructure funds that may not meet the definition".)

insufficient, it can address such concerns by issuing rules or guidance requiring disclosures to be more frequent or specific.

Similarly, preferential treatment for certain investors may, in certain circumstances, be appropriate and reflect sophisticated investors' freedom of contract. To the extent that the Commission identifies circumstances in which preferential rights provided to certain investors materially impacts other investors, the better solution is to require more specific disclosures of such categories of preferential treatment.

The Adviser-Led Secondaries Proposal would require an adviser to obtain a fairness opinion in connection with adviser-led secondary transactions ("Adviser-led Secondaries"). Underlying the Proposal appear to be investor protection concerns on the part of the Commission where an adviser has a conflict of interest in "structuring and leading" such a transaction.

On the basis of our collective experience, we believe that material conflicts of interest are not inherent in every permutation of an Adviser-led Secondary; the experience of our members includes numerous situations where the interests of an adviser and its clients were and are aligned. As the Proposing Release observes, "[i]nvestments in closed-end private funds are typically illiquid and require a long-term investor commitment of capital". Adviser-led Secondaries were initially developed in response to situations in which advisers' and investors' anticipated and desired liquidity schedules were frustrated. That an entire asset class (the Proposing Release cites a $26 billion estimate) has developed around these transactions, we submit, strongly underscores the need for this structure and its enthusiastic adoption by the market and it also, we believe, indicative of a broad alignment between advisers and investors.

We recognize that there have occurred and will occur situations in which an adviser may have a conflict of interest in organizing an Adviser-led Secondary, and we agree that investor safeguards are necessary. However, we believe that these safeguards (i) currently exist and (ii) function well. Under current law and market practice, a typical Adviser-led Secondary requires client and investor consent. A single transaction may require several layers of consent; it is not unusual for an adviser to be securing consents from fund directors, a limited partner advisory committee ("LPAC") and LPAC members, and key investors – in addition to the investor-level consents inherent in decisions to participate (or not) in an Adviser-led Secondary. These consents often are required or governed by the charter agreements of the participating entities, the relevant corporate and securities laws, and antifraud statutes and regulations in the United States and in other jurisdictions implicated in the transaction (commonly, Delaware, the Cayman Islands, and Ireland or Luxembourg).

These agreements, laws, and regulations, as well as common practice, invariably require disclosures by and from the related advisers to the affected investors and gatekeepers, which are governed by numerous antifraud regimes. This creates a broad, deep, and multijurisdictional web of liability for an adviser's misstatements or material omissions in structuring an Adviser-led Secondary.

Fairness opinions are often deemed appropriate to (and are obtained in) Adviser-led Secondaries. Many situations exist, however, in which a fairness opinion would prevent or endanger the transaction's consummation (because, for example, time constraints make such an option impracticable or impossible) or would make it more costly or complicated, none of which are in the interests of investors.

The value of fairness opinions is often less than advertised. For example, they often rely upon representations made by the adviser, which effectively means that the value of the opinion is only as good as the disclosures made by the adviser. In other words, we would submit that in some significant ways, the protections offered by a "fairness opinion" may be no greater than provided by the existing disclosure regime.

Given the sophistication and power of investors in private funds (and that of the other gatekeepers involved), we firmly believe that a regime that uses disclosure and informed consent as the preferred method to resolve conflicts is more consistent with Congressional intent and the history of the Advisers Act. Clear, relevant, and effective disclosure should be and remain the touchstone for resolving conflicts of interest involving complicated matters pertaining to sophisticated investors, and the Commission should not seek to insert well-intentioned prohibitions and requirements into that process.

B. Prohibitions Should be Narrowly Tailored to Fraudulent Activities.

In our judgment, prohibitions on advisers to private funds should be narrowly tailored to activities that the Commission has deemed to implicate specific antifraud concerns, which the Commission has authority to prohibit under Section 206(4). As noted above, the Fiduciary Interpretation makes clear that the fiduciary relationship between advisers and their clients can be shaped by the sophistication of such clients (or their investors, when the clients are funds), and that disclosure and informed consent are an appropriate way to satisfy conflicts of interest between advisers and sophisticated clients and investors.

A disclosure and consent approach would be consistent with the existing rules promulgated under Section 206(4), which restrict (i) certain advertising or marketing practices, (ii) certain political contributions that the Commission has deemed to have the potential for corruption in soliciting investments by government entities, (iii) arrangements whereby advisers have custody of client funds or securities without taking steps to ensure that such assets are appropriately safeguarded, and (iv) statements, omissions, practices or courses of business that could be fraudulent, deceptive or manipulative with respect to an investor or prospective investor in a pooled investment vehicle. The other rules promulgated under Section 206(4) require RIAs to establish policies and procedures and take other steps to ensure compliance with the Advisers Act and to make certain disclosures to investors regarding proxy voting. Each of these rules was premised on specific concerns that the Commission articulated regarding the potential for fraudulent conduct. Prohibitions applicable to private fund advisers should follow the same approach.

C. The Quarterly Statements Proposal Should be Modified to Provide Greater Flexibility.

In our experience, our clients are committed to transparency with private fund investors, including with respect to the performance of investments and the costs of investment. We recognize that the Commission has a vested interest in ensuring that investors have greater transparency, however we believe that a principles-based approach as is reflected in the Commission's 2020 amendments to Advisers Act Rule 206(4)-1 (the "Marketing Rule") would allow for greater consistency with firms' performance calculation and reporting activities. In particular, we recommend that the Commission permit advisers greater flexibility in selecting the performance metrics that they show to clients, so long as net performance is shown with equal prominence with gross performance (as is required by the Marketing Rule) and the calculation methodologies and key assumptions of such performance calculation methodologies are prominently disclosed to investors.[70] In addition, advisers should have the flexibility to show expenses on an annual, rather than quarterly, basis that reflects a clearer picture of fund expenses given different payment cycles, which may not align with a quarterly requirement.[71] An annual approach is also consistent with the requirement to deliver audited financial statements on an annual basis under the Custody Rule. We are not providing comment on the entirety of the Quarterly

[70] The highly prescriptive nature of the proposed quarterly statement requirement contrasts markedly with the approach taken by the Commission in relation to Form PF, which many private fund advisers are required to file. Question 17 of Part 1.b of that form requires an adviser to report the performance of a reporting fund based on how, and how frequently, the adviser actually calculates such performance. The Commission took pains not to require RIAs to do performance calculations specifically for the Form PF, noting its concern over the burden that such a requirement would impose on such advisers. *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Advisers Act Release No. 3308, Oct. 31, 2011 at 67-8.

[71] We note that while it is common practice in the industry for an RIA to provide a periodic statement to its retail clients, or at least to have the client's broker provide such statements, outside the requirements of the Advisers Act custody rule, when applicable, RIAs are not subject to any regulatory requirement to furnish account statements to retail clients or any requirement as to the content or frequency of such statements.

Statement Proposal, and these suggestions should not be interpreted as an expression of support for that proposal.

D. The Audit Proposal Should Be Modified.

The Audit Proposal should be modified to harmonize its requirements with the audit approach under the Custody Rule, such that satisfaction of audit approach under the Custody Rule should satisfy the requirements of the Audit Proposal (or vice versa). In addition, the Audit Proposal should be modified to specifically exclude advisers with their principal place of business outside the United States ("Non-U.S. Advisers") from being required to obtain audits for private funds organized outside of the United States. This has historically been the Commission's approach under the Custody Rule, which is not applicable to Non-U.S. Advisers with respect to their activities with respect to non-U.S. clients, including private funds organized outside the United States. This approach better comports with the principles of international comity and investors' expectations when investing in non-U.S. funds managed by Non-U.S. Advisers.

CONCLUSION

The Committee and Subcommittee appreciate the opportunity to comment on the Proposed Rules and respectfully requests that the Commission consider the comments and recommendations set out above. Members of the Drafting Committee are available to discuss these comments should the Commission or the staff so desire.

Very Truly Yours,

Jay H. Knight
Chair of the Federal Regulation of
Securities Committee

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