August 9, 2022

Via Electronic Mail: rule-comments@sec.gov

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

Re: Private Fund Adviser Proposal; File No. S7-03-22

Dear Ms. Countryman,

We, the undersigned, are managed account platform providers to institutional investors — including governmental and corporate pensions, foundations, and endowments — which invest in the U.S. capital markets in order to meet to the long-term needs of their beneficiaries, which include millions of Americans.

We support the Commission's efforts to protect the interests of investors in the US capital markets. However, it is our belief that the above-referenced proposed rulemaking would be fundamentally destructive to the managed account mechanism that such institutional investors commonly employ to achieve customized solutions tailored to meet their specific goals and to protect their specific interests. In particular, we believe the proposal has the potential to decrease, rather than increase, the transparency provided by private fund advisers ("Managers"), thereby reducing day-to-day accountability and increasing the investment and operational risks traditionally associated with investment in the alternatives asset class.

For the reasons set forth in this letter, we believe that any rulemaking should include carve outs for private fund vehicles that are structured as dedicated managed accounts for sophisticated institutional investors. Furthermore, the Commission should ensure that Managers would not be prohibited from providing investment advice to a dedicated managed account even if that would result in the dedicated managed account holder having transparency or other "rights" that would not otherwise be available to investors in such Manager's commingled fund.

Background:

Since the 2008 financial crisis (and, separately, the discovery of the Madoff ponzi scheme), the managed account industry has developed as the industry's answer to the imbalance of control and limited transparency historically pervasive in the hedge fund space.

The term "managed account" is used in various and divergent ways. On a "dedicated managed account" platform, each client portfolio is housed in a separate vehicle (or a cell of a segregated portfolio company) in order to ring-fence the assets and liabilities associated with the trading strategy of the underlying Manager. The client's allocation to each Manager is achieved through the purchase of equity interests in the vehicle or cell (each such vehicle or cell being a "dedicated managed account" or "DMA"). For asset managers, the DMAs may become constituents of a fund-of-funds or sub-advised product marketed to its investors or may form the building blocks of one or more bespoke fund-of-fund or sub-advised portfolios customized for specific investors.

The DMA structure differs fundamentally from the conventional hedge fund structure as well as the "fund-of-one". In a conventional hedge fund structure, the Manager sponsors the formation of the fund vehicle and designs investor rights which are typically subordinate to the interests of the Manager. The Manager is also the party responsible for the fund's portfolio trading activities, as well as the day-to-day operations of the fund. The Manager's duties and responsibilities are set out in an investment management agreement (an "IMA") or, in some cases, in a limited partnership agreement, between the Manager and the legal entity formed by the Manager to house fund assets. The terms of these IMAs and similar governing documents are dictated by the Manager itself and not typically negotiated on an arms' length basis with investors, who invest post-launch after the governing agreements are executed.[1] An institutional investor may seek to limit co-investor risk by requiring that the Manager form a "fund of one," to be solely owned by the institutional investor. In such cases, the governing documents may be subject to an element of negotiation, but the Manager remains in control of day-to-day operations, trading activity and oversight of service providers such as the fund administrator, and the investor's transparency into such operations as well as the fund's holdings are considerably limited.

For both asset owners and asset managers alike, investing in hedge fund strategies through a DMA provides important investor protections when compared to the alternative of investing directly into a Manager's commingled fund, including:

- **Independent Governance and Oversight** – The governing body of the DMA is installed by the client or its managed account provider, and not the Manager. As a result, the governing body is not conflicted in its allegiance to the investor or influenced by a broader commercial relationship with the Manager.

- **Asset Control** – Assets are held in accounts set up by the managed account provider in the DMA's name, with only limited and revokable trading authority conferred on the Manager through a DMA-customized IMA. As a result, the Manager has no authority to unilaterally obstruct the client's access to the assets with "lock-ups", "gates" or other common fund liquidity constraints that the client cannot negotiate in advance, and can be terminated or replaced at any time (subject only to contractual undertakings negotiated in the IMA). Assets are also subject to valuation and audit processes independent of the Manager, allowing the investor to apply methodologies consistent with those used at the enterprise level.

- **Investment, Operational and Expense Transparency** – Assets are held in the name of the DMA, which is used by the managed account provider to produce daily holdings reports, as well as risk analytics, performance attribution analytics and investment guideline compliance monitoring. Clients may also request additional data sets, such as ESG scoring and liquidity classifications using methodologies consistent with the manner in which the client consumes similar data at its enterprise level (thereby making the data more meaningful). DMA service providers, brokers and trading counterparties are engaged

[1] Depending on the legal structure and contractual arrangements of the DMA, the managed account provider may also provide its services to a DMA as a fund "manager" pursuant to an IMA; however the IMA would be subject to negotiation and input from the underlying DMA clients prior to investment, and ultimately the actual trading is conducted by a third-party Manager allowing for the governance and oversight sought by the DMA clients.

directly by the DMA and are selected or controlled by the client or its managed account platform provider. The Manager has limited authority to incur expenses on behalf the DMA, or to procure reimbursement of its own out-of-pocket expenses without prior agreement of the client.

- **Customization** – The DMA structure affords clients the flexibility to design investment strategies, investment parameters, fee structures, defensive overlays and other commercial attributes which reflect the client's values and sensitivities (e.g., to promote and enforce environmental or diversity and inclusion objectives or to clearly demonstrate the application of fiduciary and governance models imposed by the client's stakeholders and beneficiaries).

The absence of control and the limited transparency available to private fund investors means that investors are exposed to significant operational, valuation, fraud and co-investor risk in addition to their assumed investment risk. By transferring their hedge fund allocations to a managed account format, where the investor sponsors formation and so controls the design of the structure and the investor rights, institutional investors have been able to drive meaningful enhancements in the control environment, often over the objections of hedge fund managers. The managed account industry has grown quickly since 2008 and now accounts for $170bn, or approximately 5%, of all hedge funds assets accordingly to a 2020 Goldman Sachs survey.

The Commission's Proposed Private Fund Advisers Rule has the potential to curtail the client-specific customization inherent in a managed account structure and may bolster any Manager objections to what is essentially a client-centric structure by adding regulatory compliance concerns. Moreover, any rulemaking that would prohibit a Manager from providing portfolio transparency to a DMA (something that is inherent in the very nature and structure of every DMA given that the accounts are in the name of the DMA itself, as further described below), could potentially prove to frustrate the very existence of the DMA market and these vehicles which our institutional clients have come to rely on for added governance, oversight and protections.

Comments:

A. *Prohibition on certain types of preferential treatment by any private fund adviser that the Commission has deemed to "have a material negative effect on other investors," including "preferential terms" to certain investors regarding redemptions or information about portfolio holdings or exposures.*

As described above, the DMA structure inherently provides the DMA investor with holdings transparency, asset control and liquidity which may be viewed in abstract as "preferential" to other clients of the Manager pursuing a substantially similar investment strategy. This transparency and liquidity do not, however, create material opportunity to "front run". The time and costs involved in setting up a DMA (e.g. negotiating the IMA and putting fund administration and trading agreements in place) means that DMA investors are less likely to redeem their investment or otherwise liquidate their DMA quickly. The organization expense (and formal liquidation expense) of a DMA makes the structure viable only at larger allocation sizes (e.g. upwards of $50M per Manager). Consequently, the DMA structure does not lend itself to opportunistic high-turnover

allocations or to using the transparency in a manner adverse to the Manager (which would typically create an IMA termination right for the Manager and ample incentive to exercise that right).

Rather, as noted above, DMA investors primarily use holdings transparency for governance purposes. In many instances, DMA investors often seek to limit sharing or "wall-off" holdings information from their own internal trading teams to avoid regulatory impact on their own trading activities (e.g., aggregation of positions for CFTC speculative limits or coming into possession of material non-public information). Managed account providers use daily holdings data to monitor the portfolio for compliance with contractual exposure and leverage limits and sanction prohibitions, detect style drift, analyze look-through portfolio exposure and diversification at the enterprise level, and to assess ESG compliance in a manner consistent with the investor's preferred methodology. **Reverting to a position where investors are forced to rely on Managers to police themselves would erase important and hard-won protections that have made hedge fund exposure more acceptable to pension plans and other large institutional investors over the past decade.**

Similarly, DMA investors use the asset control inherent in a DMA to enhance their ability to continue meeting enterprise-level obligations during various market cycles, unhindered by the disparate (and potentially capricious) commercial interests of their Managers.

B. *Charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment.*

Managers are already subject to a fiduciary responsibility that includes the requirement to allocate expenses to clients fairly and equitably. What is "fair and equitable" may not necessarily mean pro-rata relative to the investment allocation. An example is the allocation of investment-related legal expenses relating to a private equity or private credit investment, where a DMA may require distinct legal analysis (based on differing tax or regulatory circumstances) in order to make the same investment. In our experience, our clients agree that the Manager is best placed to assess the nuances of facts and circumstances that impact the allocation of such expenses, subject to the pre-existing confines of the Manager's fiduciary responsibility, including maintaining supporting documentation which should be made available to investors for review.

Conclusion and Proposal:

Managed Accounts have been used for decades in the mutual fund industry to achieve similar transparency, customization and investor control as DMA clients are seeking in the realm of hedge fund investing. Moreover, the existing Investment Company Act regulatory framework exempts from registration investment companies offered solely to investors deemed to have the financial means and sophistication to make investment decisions in a disclosure-based environment. The Investor Advisers Act framework supports this by adding fiduciary obligations and requirements on Managers to disclose information material to such investment decisions. The proposed Rule steps significantly beyond the historical fiduciary and disclosure-based framework to add outright prohibitions on arrangements negotiated between sophisticated parties. Based upon our experience in servicing private fund investors, the underlying public policy considerations do not

account for the commercial goals of the very investors such rule-making seeks to protect. However, if such rule-making is nevertheless deemed necessary, the harmful impacts described above would be mitigated by explicitly excluding the concept of a dedicated managed account, which we would define for such purposes as any private fund formed by a client, or by a gatekeeper on behalf of a client, whereby the Manager is contractually engaged by the private fund for investment advisory and related operational services only.

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We thank you for your attention to the enhancement of investor protection in the private fund space and look forward to working with you on policies that will serve institutional investors without restricting the ability of sophisticated investors to collaborate with private fund managers to design structures suited to their individual needs and goals.

Respectfully yours,

INNOCAP INVESTMENT MANAGEMENT INC.

By:_____

Name: Evelyne Morin

Title: General Counsel

LYXOR ASSET MANAGEMENT INC.

By:_____

Name: Darren Edelstein

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HEDGEMARK ADVISORS, LLC

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