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<u>Via e-mail to: rule-comments@sec.gov</u>

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

<u>Reference: S7-17-11</u> July 11, 2011

Dear Ms. Murphy,

Thank you for the opportunity to provide comments on the SEC's proposed rules relating to investment adviser performance compensation. I have worked as the controller of several foreign and domestic funds of private equity funds with foreign and U.S. corporate and public pension plans and other accredited investors that were advised by a foreign investment adviser.

1. General comments

I strongly encourage the Commission to review existing academic research on the ability of investors with a net worth that exceeded the preexisting statutory threshold to make sound investment decisions and of the information that is voluntarily provided in private placement memorandums. The Commission could also use its new authority to conduct consumer testing with so called high net worth investors with varying amounts to net worth and with pension plans and review anecdotal evidence from enforcement cases. I doubt that net worth is a suitable proxy for the ability (including the negotiation power) to obtain material information that is necessary to make an informed investment decision (including to know the estimated impact of fees) and the knowledge to make a sound investment decision.

Knowing the complexity of the total fee burden (management and performance fees) of private equity funds, knowing the information that is typically voluntarily included in private placement memorandums or private equity funds and in limited partnership agreements, and knowing the additional information that is typically actively requested by prospective investors (such as public or corporate pension plans), I am highly skeptical that investors know the estimated total impact of fees or the risk through committing more capital to investments than is available from investors. While a high net worth standard may be suited to reflect a natural person's ability to bear losses, the amounts of assets under management of a pension plan is not suited as a proxy for the ability of the beneficiaries of the retirement benefits to bear losses. The beneficiaries cannot make the investment decisions of the plans themselves. They have to rely on the fiduciaries that administrate the plan. However, pension plans often do not have in-house specialist knowledge to perform an investment due diligence for complex investments, such as alternative assets or derivatives, and often even their consultants or investments advisers only claim to have such knowledge, but do not ask for information that is vital to assess the impact of fees or certain risks or negotiate protections and minimum diversification standards in limited partnership agreements.

I believe that mandatory minimum disclosures that show the estimated total fee burden (management fees and performance fees) as a percentage of actually invested capital under different investment pace, holding period and gross performance scenarios would be beneficial to determine such a basic element as the price of the investment advisory services of an investment adviser that manages a private equity fund. The scenarios should be based on the investment pace, holding period and gross performance of a fund's predecessor funds or of comparable funds (if the data is available). Since the management fees of a private equity fund are based on the committed capital rather than the capital that has actually been called from investors and invested during the investment period, the actual management fee burden on the invested capital depends on the pace at which underlying portfolio companies are found and acquired. Thus the investors bears the fee cost if there are not enough attractive portfolio companies in the market. In addition, subsequent to the investment period, the management fees are typically based on the called capital less the acquisition cost of fully realized (i.e. sold or bankrupt) portfolio companies. As a result a longer holding period of the portfolio companies has an influence on the amount of management fees and on the performance fees through the accruing of the performance fee hurdle during the holding period.

I do not think that the agencies that supervise U.S. or European pension plans can be relied upon to review a sample of investment due diligence material of pension plans in order to make an assessment of the pension plan fiduciaries ability to perform an adequate investment due diligence that allows them to assess the costs (i.e. fees), risks and potential return of investments. The beneficiaries of the retirement plan typically do not have the ability to review investment due diligence records and investment decisions and public accountants typically only audit the financial statements of pension plans, but do not audit a sample of investment due diligence records and investment decisions. Pension plans are a huge player in the private capital market and their beneficiaries are often not rich and do not have the ability to bear significant losses because they depend on the benefits to make a living during their retirement.

2. Answers to specific questions asked in the release

1. *Is the proposed use of the PCE Index as a measure of inflation appropriate? Is there another index or other measure that would be more appropriate?*

Yes, the use of the PCE Index as a measure of inflation is appropriate.

2. *Should we instead establish each future adjustment of the dollar amount tests as a new baseline for the next calculation of the dollar amount tests? If we were to adopt that approach, because the Dodd-Frank Act requires that revised thresholds be rounded to the nearest $100,000, could the establishment of new baselines at the rounded amounts, each time the thresholds are adjusted, result in the underestimation or overestimation of the effects of inflation in subsequent periods?*

No, the Commission should establish the dollar amount tests that it adopted in 1998 as the baseline for all future adjustments. Rounding to the nearest $100,000 will result in an increase of up to $50,000 or a decrease of up to $50,000. This represents a maximum error between -6.7% and 6.7% based on the baseline of $750,000. Thus the maximum positive or negative error would exceed the typically annual inflation rate. The establishment of new baselines at amounts that were rounded up or down (and new PCE baseline as of those year ends) would make such errors permanent. Using the 1998 PCE baseline will reduce the relative size of the rounding error. As several years of inflation go by, the unrounded adjusted amount will get higher and the relative rounding error will get smaller as a percentage of this higher unrounded adjusted amount.

3. *Should we, as proposed, exclude the value of a natural person's primary residence from the calculation of net worth? Or should we include the value of a person's primary residence? Does such ownership evidence financial experience and the ability to bear risks associated with performance fee contracts? Should we, as proposed, also exclude from the net worth standard in rule 205-3 debt secured by a person's primary residence, up to the market value of the residence? Does such debt affect the ability to bear risks associated with performance fee contracts or investments that often are associated with such contracts?*

Yes, the Commission should exclude the value of a natural person's primary residence and any debt secured by the primary residence (regardless of whether it exceeds the fair market value of the residence). Ownership of a primary residence does not evidence financial experience. Whether ownership of a primary residence evidences the ability to bear losses from performance fee contracts also depends on a household's income and on the rent that the household would need to pay if it would be forced to sell the primary residence.

4. *We note that although the Dodd-Frank Act requires the Commission to exclude a natural person's primary residence from the net worth standard for an "accredited investor" in rules under the Securities Act, the Dodd-Frank Act does not require the Commission to exclude a natural person's primary residence from the standards for a "qualified client" in rules under section 205(e) of the Advisers Act. Instead, the Dodd-Frank Act requires that the dollar amount tests of "qualified client" be adjusted for inflation every five years. Should our amendment of rule 205-3 accomplish only what the Dodd-Frank Act mandates (i.e., inflation-adjustment of the dollar amount tests) and not revise the net worth test by excluding the value of a primary residence?*

No, the adjustment should accomplish more than the Dodd-Frank Act mandates and should exclude both the value of the primary residence and any debt secured by the primary residence (regardless of whether it exceeds the fair market value of the residence). If the majority of both houses of congress thinks that the ability to bear losses should not include the ability to sell the primary residence to cover those losses, then this opinion of congress should also apply to the eligibility for qualified client status and the ability to bear losses from investments under performance fee arrangements.

5. *Should the rule require, as proposed, that debt secured by the residence in excess of the market value of the residence at the time the advisory contract is entered into be included as a liability in the determination of the person's net worth? Should the rule instead require that all debt that is secured by the primary residence (regardless of whether it exceeds the fair market value of the residence) be excluded from the calculation of net worth under rule 205-3? Alternatively, should the rule exclude the entire market value of the residence from net worth, but require treatment of any associated debt as a liability? Should the rule require inclusion of debt secured by a primary residence as a liability if proceeds of the debt are used to enter into an advisory contract that involves performance compensation paid to an investment adviser? If so, how would these proceeds of the debt be traced?*

No, the rule should require that *all* debt that is secured by the primary residence (regardless of whether it exceeds the fair market value of the residence) be excluded from the calculation of net worth under rule 205-3 and for the calculation of net worth for purposes of the accredited investor status. Otherwise, the client or investor would incur the time burden and cost to obtain a valuation of the fair market value of the primary residence from a real estate agent in order to know whether the debt exceeds the fair market value of the primary residence. Simply disregarding the primary residence and any debt that is secured by the primary residence will avoid having to determine a value. A valuation of illiquid property that has not been sold is subjective anyhow and the resulting estimated value may be quite far off an actual sales price. It will be difficult in practice to determine whether the proceeds of the debt have been used to enter into an advisory contract. This will be difficult to trace. As a consequence, such debt should not be subtracted from the net worth. Maybe a close proximity between the time of taking on new debt and entering into the advisory contract could work. But again, banning advisory fees for certain types of clients seems overly paternalistic and is probably not based on empirical research. I think disclosing the estimated impact of advisory fees as a percentage of invested assets through scenarios would allow an investor to make an informed assessment of the likely cost (price) of advisory fees.

6. *Should the rule provide that the calculation of net worth must be made on a specified date prior to the day the advisory contract is entered into, for example 30, 60, or 90 days? If not, would investors be likely to inflate their net worth by borrowing against their homes to attain qualified client status? If we were to require that the net worth calculation be made a significant period of time in advance of entering into the advisory contract, would such a requirement make the calculation unduly complex?*

No. The estimate should be as of the date the advisory contract is entered into and should be based on a reasonable estimate that is based on the latest information that is *already available*. Clients will only be able to base their estimate of their own net worth on account statements from banks, brokers and investment advisers. Some of those account statements may only be available quarterly or annually. As a consequence, an estimate of one's own net worth will always be based on outdated information. The values will never be exactly as of 30, 60 or 90 days prior to the day the advisory contract is entered into. Even an estimate *within* a certain number of days prior to the day the advisory contact is entered into will not work if certain account statements are only provided annually (e.g. bank account statements for saving accounts are typically only provided annually in Switzerland).

7. *Is the language of the proposed rule amendment sufficiently precise? Should we substitute the word "equity" for the word "value" when referring to the primary residence excluded from the calculation of a natural person's net worth? Should we define the term "primary residence" for purposes of rule 205-3? If so, should we address the circumstances of a person who lives in multiple residences for roughly equal amounts of time during the year?*

The use of the word value is fine if both the value of the primary residence and all debt that is secured by the primary residence are excluded from the calculation. The domestic and international tax rules typically define situations where a person has multiple residences. In the case of persons that have both a primary residence and one or more secondary residences in the U.S., referring to IRS rules would be fine. However, international investors are typically not familiar with IRS rules. In the case of international investors or of investors with residences in several countries, it would be better to refer to applicable anti-double taxation treaty and to the commentary to the OECD model tax convention.

8. *As noted above, the Commission proposed in a separate release to adjust the net worth standards for accredited investors in our rules under the Securities Act, to exclude the value of a natural person's primary residence from the assessment of a natural person's net worth. We request comment on whether the net worth standards that we consider in connection with rule 205-3 should differ from any standards we consider in connection with those proposed amendments.*

The exclusion of the value of a natural person's primary residence and of debt secured by the primary residence should be consistent for all net worth standards (e.g. accredited investor, qualified client, high net worth customer or qualified purchaser). The question whether the amounts to qualify for those statuses should be the same, depends on the Commission's judgments whether the risks and impact of not receiving all disclosures that are mandated in a registration statement and prospectus have the same magnitude as the risk and impact of suffering losses due to risky investments by the investment adviser that are motivated by the aim to obtain performance fees. Performance fees are often charged in private equity, venture capital or hedge fund agreements. Those private funds are typically placed through private placements so that an investor would need to satisfy the accredited investor standard anyhow.

9. *Should the rule be amended as proposed, to allow advisers to continue to provide advisory services under performance fee arrangements that were permitted under the rule in effect at the time the contract was entered into, if the client does not meet the eligibility criteria after an adjustment to the dollar amount tests or for any other reason (e.g., a decrease in the client's net worth below the dollar amount test)? Should the rule in these circumstances permit the management of existing funds under previous contractual arrangements, but prohibit an adviser from charging performance fees with respect to funds committed after the effective date of the rule? If so, how should the rule treat dividends and realized capital gains reinvested by the adviser?*

Yes, the proposed role should allow investment advisers to continue to provide advisory services under performance fee arrangements that were permitted under the rule in effect at the time that the contract was entered into, if the client does not meet the eligibility criteria afterwards for any reason. Yes the rules should prohibit an adviser from charging performance fees with respect to funds committed after the effective date of the rule. An obligation for the investment adviser to periodically enquire clients and investors in private funds about their net worth would be very burdensome for the investment adviser and for the clients and investors. However, such an obligation is reasonable when an existing client or investor wants to invest additional money. An investment adviser that is authorized to reinvest realized *proceeds* (i.e. realized capital gains plus the realized recovery of the acquisition cost, interest, dividend, etc.) should be permitted to do so and to charge performance fees on those assets. The fund agreements of private equity funds and venture capital funds with a limited fund life typically require the fund manager to distribute all realized proceeds to the investors shortly after the realization and can only reinvest proceeds under very limited circumstances.

10. *Should the rule be amended as proposed, to allow advisers to continue to be compensated under performance fee arrangements that were permitted when the adviser was exempt from registration with the Commission? Should the rule in these circumstances permit the management of existing funds under previous contractual arrangements, but prohibit a newly registered investment adviser from charging a performance fee with respect to any additional funds to be managed under previously existing contracts?*

Existing clients of registered investment advisers or of registered investment advisers that were previously exempt from registration and investors in private funds that are advised by such advisers that are not qualified clients should not be allowed to increase their investments unless they have an existing contractual obligation to invest additional amounts that they can only terminate against a financial penalty (e.g. have subscribed to an interest in a private equity or venture capital fund for a certain amount that has only been drawn down partially by the fund yet). Otherwise the transition for private funds with an unlimited fund life will practically take forever and there would be funds running under the old and the new regime for a very long time.

11. *Should the rule differentiate between the reasons why an adviser was exempt from registration (e.g., due to a particular subsection of the Advisers Act) but is no longer exempt? Should the rule include different transition provisions depending upon the reason why an adviser was exempt from registration but is no longer exempt?*

I assume that contracts between an investment adviser and a single individual investor can be changed more easily than fund agreements between a fund manager and a multitude of investors. However, if a performance fee is linked to realized capital gains (as opposed to unrealized capital gains due to an appreciation of the value without a sale), an automatic obligation or right for the investment adviser or the investor to terminate the contract could be problematic. Typically a performance fee is a substitute for a higher management fee. An investment adviser with a performance fee that is linked to realized profits would be negatively affected if it would be forced to terminate an advisory contract in a situation with significant unrealized profits. This could infringe constitutional guarantees relating to the protection of property in some jurisdictions. Advisory contracts with performance fees that are based on unrealized profits (with or without a high watermark) may be easier to terminate.

12. *We request comment on the transition period or delayed compliance date that would be appropriate for any revised thresholds that we issue by order, or for any rule amendments that we adopt. Should we allow more time than the 30 days required under the Administrative Procedure Act (e.g., 60 days, 90 days, 120 days)?*

Investment advisors and private funds may have already drawn up fund agreements and private placement memorandums that include a performance fee and may already be in the fundraising process to offer interests in such funds to private investors. Some investors may already have subscribed to interests in the fund and may have signed a partnership agreement on the understanding that the fund would include performance fees. It could be quite an administrative hassle to go back to all private investors that have already subscribed and to tell them that they cannot join the fund now. In addition, the actual starting of fund may be explicitly or implicitly contingent on reaching a certain amount of subscribed assets so that the advisory fees break even with the cost of operating the fund. A fund raising process for a private equity fund can take many months. As a consequence, I recommend a rather long transition period (i.e. at least 120 days).

13. Comment on costs for the cost-benefit-analysis

The cost benefit analysis should include the cost of consulting legal counsel to resolve and to obtain no-action letters to resolve legal uncertainties and to get to know how to implement those rules in practice. They should also include the cost of obtaining valuations from real estate agents in order to be able to determine whether the debt that is secured by the primary residence exceeds the value of the primary residence. This is the reason why I recommend to disregard the full amount of the debt regardless of whether it exceeds the fair market value of the residence. The cost benefit analysis should also include the cost, including legal counsel fees, to adjust any existing contracts and to obtain the consent of clients and investors if the final rules require any changes to existing contracts.

I appreciate the opportunity to comment on these matters and hope that my comments are useful in the rulemaking process. Please do not hesitate to contact me by e-mail if you have any follow-up questions.

Respectfully submitted,

Georg Merkl