AMERICAN INVESTMENT COUNCIL
Growth Through Long-Term Investment

June 13, 2022

VIA ELECTRONIC SUBMISSION

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

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (SEC Release No. IA-5955; File No. S7-03-22 (February 9, 2022)).

Dear Ms. Countryman:

The American Investment Council ("**AIC**") writes to supplement its comments[1] on the proposed rules (the "**Proposal**") regarding investment advisers to private funds.[2] As AIC previously explained, private equity funds[3] have delivered billions of dollars in returns for investors and have helped launch countless valuable U.S. companies and products. The Proposal will stifle this vibrant sector of the U.S. economy—saddling it with unjustified burdens and constraints, and curbing the entrepreneurialism, flexibility, and strong record of success that have made private equity funds such an attractive option to investors.

This letter supplements AIC's April 25 comments in two respects. First, attached as Appendix A hereto are AIC's answers to a select group of questions posed by the Commission in the Proposal. It is not practicable for AIC to address each of the hundreds of questions posed in the Proposal, and the Commission should therefore draw no inference from the fact that AIC has not answered a particular question. If the Commission is interested in AIC's views on any questions not addressed here, we would of course be pleased to discuss them with the Commissioners or the Staff.

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[1] Comments of the American Investment Council, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126669-287340.pdf.

[2] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,886 (Mar. 24, 2022). All citations to the Proposal will refer to the Federal Register page unless otherwise indicated.

[3] For purposes of this letter and the attached appendix, we generally use the terms "private funds" and "private equity funds" to encompass private equity funds, private credit funds, and other permanent capital vehicles. We refer to their investment advisers as private fund advisers, private equity fund advisers, and fund sponsors.

Second, AIC submits this supplemental comment to note the unusually widespread concerns with the Proposal expressed by commenters to date. The Proposal faces overwhelming opposition across the full spectrum of private fund advisers.[4] Even more remarkable, however, is the degree to which the investors the Commission claims to be helping—the limited partners (LPs) that invest in private funds—agree that the Proposal presents a number of significant concerns. While these investors support aspects of the Proposal and the Commission's underlying policy objectives, it is extraordinary, in our experience, for the intended beneficiaries of a proposed rule to express reservations about so many of the proposal's terms. This range of concerns—from advisers and investors alike—is a powerful indication that the Proposal rests on an insufficient understanding of the private fund market the Proposal would so comprehensively regulate.

The error reflected in the comment file is one not just of substance, but of process. Simply, the Commission is proceeding too quickly, allowing neither the public nor Commission Staff the time needed to develop thoughtful, properly-tailored proposed rules. This truncated process, exacerbated by the huge volume of Commission proposals, risks leading to final rules that are not fully informed by the data and insights available from market participants who must live under the rules.[5] Misunderstandings, errors of judgment, and far-reaching unintended consequences are the inevitable result of such a breakneck pace.[6]

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[4] *See*, *e.g.*, Comments of the Private Investment Funds Forum, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126625-287267.pdf; Comments of the National Venture Capital Association, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20130106-296800.pdf; Comments of the Securities Industry and Financial Markets Association, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126748-287461.pdf; Comments of the Managed Funds Association, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126631-287270.pdf; Comments of the National Association of Private Fund Managers, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126565-287200.pdf; Comments of the National Association of Investment Companies, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 22, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126661-287366.pdf.

[5] The currently-pending SEC rule proposals span more than 700 pages in the Federal Register. Comments of the U.S. Chamber of Commerce 7, SEC Release No. 33-11042, File No. S7-10-22 (Apr. 19, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20124058-280187.pdf. And while under the past two Commission Chairs the Commission provided comment periods of at least 60 days for approximately 90 percent of proposals, the current Commission has allowed only 30-day comment periods for approximately 75 percent of its proposals. *Id.* at 5; *see also* Comments of 47 Members of Congress 1, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 13, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20127548-288697.pdf (writing to "express concern over some of the Securities and Exchange Commission's comment periods for complex rulemakings that may hamper the ability for the public to provide effective and meaningful input").

[6] The private fund advisers proposal is not the only recent proposal to display significant misunderstanding of the activity it would regulate. For example, 85 law and finance professors recently wrote the Commission to express concern that the "relatively low, and complex, threshold for triggering" a proposed swaps position reporting requirement would "significantly deter shareholder activism." Comments of 85 Law and Finance Professors 2, SEC Release No. 34-93784, File No. S7-32-10 (Mar. 21, 2022), https://www.sec.gov/comments/s7-32-10/s73210-20120780-272960.pdf. And a separate group of law and finance professors wrote to "urge the Commission to consider" academic literature on short selling that the

To illustrate for the Commission the shared concern that exists among commenters to the Proposal, we summarize below several views expressed from commenters representing LPs—the intended beneficiaries of the proposed rules:

1. Investors rely on the enormous financial benefits that private equity has delivered, and urge the Commission to proceed with caution. According to the Institutional Limited Partners Association ("**ILPA**"), an association of private equity investors, "[p]rivate equity has delivered enormous long-term financial benefits to LPs, and by extension, the millions of people and essential programs they serve."[7] Other investors, including private credit investors, have had a similar experience. The Comptroller of the State of New York as Trustee of the Common Retirement Fund has been "investing in private equity [since] 1983," and continues to find that private equity "play[s] an important role" in its investment strategy.[8]

Likewise, the Ohio Public Employees Retirement System stated that "[o]ver the past 10 years, private equity has consistently been one of [the retirement system's] top performing asset classes, with net time-weighted return of 16.8%."[9] For example, in 2021, "net returns from investments in private equity were 44.8%, compared to the 15.3% returns of the total defined benefit plan."[10] Furthermore, private equity "currently represents more than 12.5% of [the retirement system's] total assets."[11] It is thus, the retirement system has explained, "difficult to overstate the contribution that private equity has made to [the system's] ability to sustainably provide secure retirement benefits for [its] members."[12] These results have been achieved in the context of a market that is highly competitive.[13]

Commission had overlooked—literature that indicated that proposed short-sale disclosure requirements "would impose significant costs on short selling and deter short selling activity, with potentially harmful consequences." Comments of Professor Barbara Bliss et al. 1-2, SEC Release No. 34-94313, File No. 27-08-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-08-22/s70822-20126591-287247.pdf.

7 Comments of the Institutional Limited Partners Association 6, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126586-287243.pdf; *see also id.* at 1 ("As we have indicated in our prior comments to the Commission, private markets are a critical component of the total return of our members' investment portfolios.").

8 Comments of the Comptroller of the State of New York as Trustee of the Common Retirement Fund 1, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126603-287255.pdf.

9 Comments of the Ohio Public Employees Retirement System 2, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126471-287115.pdf.

10 *Id.*

11 *Id.*

12 *Id.*

13 The market for investment advice is highly competitive, *see Buyout Giants Fight to Win Over Investors 'Spoiled for Choice,'* Bloomberg Law (Apr. 28, 2022), https://news.bloomberglaw.com/securities-law/buyout-giants-fight-to-win-over-investors-spoiled-for-choice, and private equity investors have benefited from that competition. Coller Capital's *Global Private Equity Barometer* finds that "[o]ver 70% of LPs report that their private equity portfolios have outperformed their public equity holdings since the Global Financial Crisis." Coller Capital, *Global Private Equity Barometer*, Summer 2022, at 4, https://www.collercapital.com

We believe these and other commenters' views should cause the Commission to proceed with caution, if at all. As the Ohio Public Employees Retirement System letter explains, the Proposal is "far-reaching" and will have a significant impact on the "development of the private markets or the returns [investors] receive" from those markets—an impact that "cannot [be] ignore[d]."[14]

2. The ban on liability limitations would have significantly disruptive effects on private funds. As ILPA recognizes, private fund advisers consider certain limitations on liability to be "necessary" to provide advisers the breathing room they need "to execute [the] higher risk, higher return investments" investors want, and thus deem liability protections "essential to the [private funds] business model."[15] The Proposal would eliminate these essential, commonplace provisions, exposing advisers to potential liability and substantial legal costs, even for alleged mistakes made in good faith pursuit of a fund's best interests. This is "untenable."[16] As ILPA states, subjecting advisers to liability for "ordinary negligence" would have a multitude of "unintended consequences,"[17] from "exorbitant" insurance premiums,[18] to the "the possibility that advisers' risk tolerance will be fundamentally impacted and potentially damage the returns produced by private funds."[19] Thus, ILPA supports continuing to permit advisers to seek indemnification, at least for simple negligence (subject to a limited proviso).[20]

/sites/default/files/Coller%20Capital%20Global%20Private%20Equity%20Barometer%20Summer%202022.pdf. Anecdotes abound. The Public School & Education Employee Retirement Systems of Missouri explains that a "long-term commitment and investment in the private equity asset class has enhanced our ability to deliver on our mission of providing retirement security to Missouri's educators and education employees . . . . Private equity, within the Missouri PSRS/PEERS investment portfolio, has produced net-of-fees returns significantly greater than the returns achievable in publicly traded stocks over all time periods." Am. Inv. Council, *Private Equity Delivers the Strongest Returns for Retirees Across America* (2021), https://www.investmentcouncil.org/wp-content/uploads/2021_pension_report.pdf. The Illinois State Board of Investment adds that public pension funds "all have a certain objective and investment return that [they] are trying to achieve," and that "asset classes like private equity are necessary to be able to achieve those targets." *Illinois State Board of Investment Earns Highest Private Equity Returns of Any Public Pension Fund*, Am. Inv. Council (July 19, 2021), https://www.investmentcouncil.org/new-video-illinois-state-board-of-investment-earns-highest-private-equity-returns-of-any-public-pension-fund/. And the Texas Municipal Retirement System states that "given the returns, there is a huge opportunity set in PE" for investors to "enhance" performance. Aaron Weitzman, *Texas Municipal has record year of commitments as it looks to boost PE allocation*, Buyouts (Oct. 28, 2021), https://www.buyoutsinsider.com/texas-municipal-has-record-year-of-commitments-as-it-looks-to-boost-pe-allocation/.

[14] Comments of the Ohio Public Employees Retirement System, *supra* note 9, at 2.

[15] Comments of the Institutional Limited Partners Association, *supra* note 7, at 18.

[16] *Id.*

[17] *Id.* at 2.

[18] *Id.* at 18.

[19] *Id.* at 2.

[20] *Id.* ILPA does generically object to what it characterizes as a growing use of liability-limiting provisions, *id.* at 17–18, though it does not cite any examples where such a provision caused financial loss to investors.

3. The proposed restrictions on certain practices related to side letters reflect basic misconceptions about the operation of private funds. According to ILPA, side letters "are an essential tool" used by investors to tailor the terms of an investment to an investor's particular needs and circumstances.[21] Many investors have internal policy requirements or face certain regulatory obligations that differ from or are not addressed by a fund's standard offering documents. For example, the Common Retirement Fund of New York "is subject to various laws, regulations and policies that compel the [Fund] to seek and procure certain rights with respect to its private fund investments."[22] The Ohio Public Employees Retirement System, likewise, must "negotiate individual liquidity options from a fund should its sponsoring state legislation require it to divest its holdings in private market investments."[23] Without these type of institution-specific provisions created through side letters, "*the majority of institutional LPs would not be able to invest in private funds*" at all.[24] The fact that some but not all LPs are under state-law obligations that necessitate certain side-letter agreements would not be a basis to permit those investors—and not others—to make side-letter agreements. That would hard-code into the regulatory regime the very "preferential" treatment the Proposal decries, allowing government instrumentalities terms that the sponsoring government deems prudent, but denying those same terms to other investors merely because they are private rather than government-sponsored. This result would be arbitrary and improper.

We do not believe that the Commission's objectives are to diminish access to private funds, but many investors "fear" that "might be the consequence" of the Proposal.[25] As ILPA observes, the Proposal adopts a "facts and circumstances standard for determining" whether certain side-letter provisions will be deemed by the Commission to have a material, negative impact, and thus be barred by the Proposal.[26] This facts-and-circumstances test creates substantial uncertainty, which may "impede [investors'] ability to negotiate for side letters" by causing advisers "to take a conservative view on what the SEC may deem material, negative impacts," and to therefore feel that they must "resist making side letters available" to avoid an SEC sanction.[27] The Comptroller of the State of New York thus recommends dropping this aspect of the Proposal entirely, and we agree.[28] Other investors urge the Commission to provide much "greater specificity as to the nature of the terms" the Commission seeks to prohibit,[29] and

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21 *Id.* at 4.

22 Comments of the Comptroller of the State of New York, *supra* note 8, at 7.

23 Comments of the Ohio Public Employees Retirement System, *supra* note 9, at 9.

24 Comments of the Institutional Limited Partners Association, *supra* note 7, at 4 (emphasis added).

25 Comments of the Comptroller of the State of New York, *supra* note 8, at 7.

26 Comments of the Institutional Limited Partners Association, *supra* note 7, at 4.

27 *Id.* at 4–5; *see also* Comments of the Comptroller of the State of New York, *supra* note 8, at 7; Comments of the California Public Employees' Retirement System 3, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20127881-289394.pdf.

28 Comments of the Comptroller of the State of New York, *supra* note 8, at 8.

29 Comments of the Institutional Limited Partners Association, *supra* note 7, at 5.

to make clear that the Proposal "does not prohibit investors from entering into bespoke arrangements with private fund advisers to secure essential institution-specific requirements."[30]

Continued access to private funds is not investors' only concern: the Proposal would eliminate certain side-letter provisions that, investors acknowledge, are "critical to the health of fundraising and capital formation," that "encourag[e]" and "facilitat[e] new entrants to private markets," and that "hel[p] institutional investors secure the returns they need for their beneficiaries."[31] For example, certain large, "anchor" investors may be willing to provide a disproportionate amount of a fund's initial capital.[32] Securing these large investors benefits the entire fund, and thus, advisers are often willing to offer anchor investors special accommodations. As ILPA explains, this "differentiated treatment is an accepted market practice by both [investors] and advisers and *not* deemed to harm other investors in the fund."[33]

The Proposal reflects a misunderstanding of not only the substance and economic significance of side-letter provisions, but also of the entire side-letter process. The Proposal would prohibit providing side-letter rights to any investor unless the adviser provided advance written notice of those rights to prospective investors. As ILPA and CalPERS explain, however, private funds already have a well-functioning notice process that runs "*after* the final close of a closed-end fund."[34] The "requirement to provide [advance] written notice of preferential terms to prospective investors would be procedurally misaligned with the [preexisting] process"[35]—in other words, entirely infeasible. "In most closed-end fund negotiations, side letters are negotiated up to the final moments before the fund's final close."[36] As a result, requiring "disclosures of side letter terms" before the fund's final close "would be an inaccurate and incomplete reflection of the provisions secured by other LPs in the fund" and might offer "little to no utility in shaping the LP's negotiating priorities."[37] Thus, as proposed, the notice requirements "would be excessively burdensome without yielding decision-useful information" for investors.[38]

As these comments demonstrate, the Commission's proposed restrictions on certain practices related to side letters reflect basic misconceptions about the operation of private funds, and, as a result, threaten the unintended consequence of making it substantially more difficult for LPs to invest in private funds.

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30 *Id.*; Comments of the California Public Employees' Retirement System, *supra* note 27, at 3.

31 Comments of the Institutional Limited Partners Association, *supra* note 7, at 22.

32 *Id.*

33 *Id.* (emphasis added).

34 *Id.* at 5; Comments of the California Public Employees' Retirement System, *supra* note 27, at 3.

35 Comments of the Institutional Limited Partners Association, *supra* note 7, at 5.

36 *Id.*

37 *Id.*

38 *Id.* at 22.

4. The "blanket prohibition" on non-pro rata fee and expense allocation is problematic.[39] Multiple investors have urged the Commission to "take another look"[40] at this prohibition and to "conside[r] a more nuanced solution."[41] Sponsors often need co-investment capital from one or more large investors to execute a private fund transaction or for other purposes. To secure this co-investment, it often "make[s] sense for the fund and its investors" to agree to a non-pro rata allocation of fees and expenses.[42] The Proposal's blanket prohibition on this practice is "problematic"[43] and fails to "consider the practicalities and processes" of the private funds market.[44]

5. The fairness-opinion proposal for adviser-led secondaries is misguided. Adviser-led secondaries offer private funds and their investors an alternative way to exit portfolio investments. The Proposal would require private fund advisers to obtain and distribute to investors a fairness opinion from an independent opinion provider before closing on an investment in an adviser-led secondaries transaction. As ILPA explains, however, investors "generally deem fairness opinions to offer procedural comfort *but not true assurance* of fair pricing of the transacted assets."[45] "Other methods, such as through a partial disposition to a third-party or an arms-length transaction through a minority stake sale to another adviser and independent of the proposed secondary are perceived to yield more valuable information on the fairness of the pricing offered."[46] The availability of such mechanisms obviates the need for a fairness opinion. At any rate, the Commission should leave to market participants to decide whether or not the cost of a fairness opinion is justified by the benefits in specific situations.

6. The proposed clawback reduction ban will harm investors. A clawback refers to an adviser's obligation, under the fund's governing agreements, to return excess performance-based compensation to the private fund. The Proposal would prohibit an adviser from reducing the amount of this clawback by taxes applicable to the adviser. Investors in private funds recognize the counterproductive effect of this proposed prohibition. ILPA, for example, has observed that this prohibition "could yield unintended consequences harmful to LPs, in that" future fund agreements "may be structured to eliminate [any] clawback" at all, and that "managers would seek to limit clawback events or to slow distributions over time to limit tax exposure."[47] This would be "particularly" true for "managers less able to bear [the] exposure or uncertainty" of a

39 Comments of the Ohio Public Employees Retirement System, *supra* note 9, at 7.

40 Comments of the Comptroller of the State of New York, *supra* note 8, at 5.

41 Comments of the Ohio Public Employees Retirement System, *supra* note 9, at 7.

42 *Id.*

43 Comments of the Institutional Limited Partners Association, *supra* note 7, at 19.

44 Comments of the Comptroller of the State of New York, *supra* note 8, at 5.

45 Comments of the Institutional Limited Partners Association, *supra* note 7, at 13 (emphasis added).

46 *Id.*

47 *Id.* at 17.

clawback without adjustments for taxes.[48] ILPA acknowledges these risks and thus supports the development of an alternative approach.

*7. **The Proposal will put significant implementation burdens on existing funds.*** As the Regulatory Fundamentals Group, a consulting firm representing a consortium of 25 leading nonprofit investment offices with over $200 billion in combined investable assets, explains, adoption "of the Private Fund Proposal in anything approximating its current form would be a source of considerable disruption in the industry."[49] In particular, applying the Proposal to existing funds "will require a substantial diversion of resources" as "many of the arrangements that [the Group's] members and other diverse investors have been operating under" will "need to be renegotiated."[50] This process "is likely to be a material drag on the investment performance of the endowments and foundations that comprise [the Group's] membership."[51] At the very least, therefore, and as ILPA also recommends, the Proposal (or at least most of the Proposal) "should be solely applied to new funds formed after the [Proposal's] implementation date."[52] Limiting the Proposal to newly formed funds would "avoid the necessity of renegotiating existing fund agreements, side letters and subscription agreements, the cost and uncertainty of which would be borne by LPs."[53]

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The above-summarized concerns come from private fund investors and their representatives, and we share their concerns. The Proposal reflects a basic misunderstanding of the operation of private funds and the interests of fund investors. Rather than protect and promote the interests of investors, the Proposal threatens to make investing in private funds more costly, less efficient, and potentially altogether infeasible.

To avoid these counterproductive effects, the Commission should withdraw the Proposal. If the Proposal is not withdrawn, the Commission must at minimum re-propose it for further comment. It is not possible to properly address commenters' numerous shared concerns without publishing the proposed revised language and obtaining the benefit of further public input.

To take but one example, the problems arising from the proposed restriction on limitations of liability are so great that they remain incapable of being resolved in a final rule that is not different in kind from the Proposal. In mandating this rigid, far-reaching change to advisers' legal relationships, the Commission cites no examples or evidence of harm justifying the proposed prohibition. The Proposal also gave no explanation of how the terms in the

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48 *Id.*

49 Comments of the Regulatory Fundamentals Group LLC 12, SEC Release No. IA-5955, File No. S7-03-22 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126563-287199.pdf.

50 *Id.*

51 *Id.*

52 Comments of the Institutional Limited Partners Association, *supra* note 7, at 5.

53 *Id.*

proposed prohibition should be interpreted, how those terms relate to current Commission guidance and state or foreign law, how they affect investor private rights of action, or how they relate to other provisions in a private fund's organizational documents governing standards of care, fiduciary duty, exculpation, and indemnification. It remains unclear, for example, whether the Commission intends to change the federal liability standard applicable to investment advisers, a standard rooted in *SEC v. Capital Gains Research Bureau, Inc.*[54] and which the Commission recently reaffirmed.[55] If the Commission *does* intend to change this, it must say so directly; explain why a change is justified and within its statutory authority; and allow the public an opportunity to comment. If it is *not* the Commission's intent to change this longstanding standard, it must demonstrate how each element of the Proposal can be reconciled with the standard, and then again provide the public with opportunity to comment. The resulting confusion regarding the intended meaning and consequences of this provision and its vague, undefined, and overlapping terms has deprived members of the public of the opportunity to undertake their own analysis and provide meaningful comments on both the expected impact of the Proposal as well as the Commission's understanding of its authority to promulgate the provision.

Simply, the Proposal should be abandoned. But if it is not, the Commission should conduct a far more inclusive, deliberative process than used for the initial proposed rule.

Respectfully submitted,

Rebekah Goshorn Jurata
General Counsel
American Investment Council

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[54] *SEC v. Capital Gains Rsch. Bureau, Inc.*, 375 U.S. 180 (1963).

[55] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.

AIC Comment Letter to SEC Release No. IA-5955

Supplemental Submission

APPENDIX A

Answers to Select Questions Posed in the Proposal

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

Response: The Commission should not impose any limitations on management fees or performance-based compensation. As set out in the Comment, the Commission does not have the authority to limit these terms. Further, such limitations will have unintended consequences for advisers and investors, including increased fund expenses. The Commission will thus not achieve its stated goal of investor protection by dictating commercial terms among sophisticated parties in otherwise heavily negotiated agreements.

The Commission also should not require an adviser to disclose its anticipated management fee revenue and operating budget to private fund investors. While the Commission did not propose this requirement and has provided no rationale as to why it would be needed, we do not believe that a reasonable investor in a private fund would make an investment decision based on an investment adviser's anticipated management fee revenue or the particulars of an investment adviser's operating budget. For example, the monthly dollar amount that an investment adviser pays for property leases, personnel salaries, and other overhead expenses has nothing to do with whether a fund will generate investor returns that meet or exceed expectations. Moreover, many advisers to private funds typically advise a number of different funds with varying management and fee terms, and different strategies, which can give rise to complex allocations. To present an investor in one fund with an entire picture of the adviser's operating budget and management fee revenue would reveal sensitive commercial information about the adviser's business well beyond the fund's mandate. Requiring advisers to disclose information to investors that is singularly related to the adviser's business would thus represent an unreasonable overreach that offers no additional investor protection.

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

Response: The Commission should simplify the presentation of fees and expenses in the Fund Table. Instead of requiring advisers to list each and every category of expense as a separate line item, the Commission should allow funds to group smaller expense items into broader categories or disclose them as miscellaneous expenses. This would achieve the Commission's goal of transparency without including extraneous information. Any standard the Commission adopts should match the current GAAP requirements for the presentation of fees and expenses. GAAP reporting standards require that all expenses incurred during the relevant period be included in the financial statements for that period, but allows for individual expenses to be grouped into categories, based on qualitative and quantitative considerations. GAAP therefore provides that Fund expenses are aggregated and presented in a digestible, informative way. The Commission should avoid adopting a reporting standard that has the potential to confuse investors because of differences compared to GAAP.

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

Response: The Commission should permit advisers to disclose portfolio investment compensation on an aggregate basis across all of the fund's investments rather than for each individual portfolio investment. Requiring the disclosure of such commercially sensitive information for individual portfolio investments would reveal confidential arrangements between a private company and the adviser to all of the fund's limited partners, including those who may be subject to public disclosure laws, without providing investors with actionable information. Private funds at times admit investors that are subject to state specific public record acts requirements. Because disclosure mandated under these requirements may publicly reveal confidential business information, private funds often permit advisers to withhold certain granular commercial data from these investors, where this is in the best interest of the fund. By requiring advisers to disclose portfolio company level arrangements to all investors, the Proposal may ultimately cause such information to become publicly available. Further, in the context of information that is of highly dubious materiality when unaggregated, portfolio company-level disclosure requirements will significantly increase the adviser's administrative costs, and ultimately reduce investor returns.

(iv) **Question:** The proposed rule would require advisers to prepare the statement of contributions and distributions without the impact of any fund-level subscription facilities. Would this information be helpful for investors? Would advisers be able to prepare such a statement without making arbitrary assumptions? Why or why not? For example, would advisers need to make assumptions in calculating the preferred return (if applicable)?

Response: Requiring advisers to prepare statements of contributions and distributions without the impact of subscription facilities would not be helpful to investors. While the Proposal notes that investors do not typically receive the contributions and distributions information, it fails to recognize that this is because even the most sophisticated investors do not routinely ask for this level of information across their portfolios. Therefore, mandating this additional disclosure to investors is likely to clutter meaningful reporting and confuse investors as to the importance of such data points, while increasing the cost of reporting.

If the Commission decides to mandate disclosure of a fund's use of leverage, it should do so by requiring disclosure regarding fund returns without the impact of fund-level subscription facilities, rather than a presentation of a statement of each contribution and distribution without the impact of fund-level subscription facilities. A statement detailing all contributions and distributions without the impact of fund-level subscription facilities would create a significant or overwhelming, if not useless, amount of data. Such disclosure would impose a highly burdensome obligation on advisers without providing a corresponding benefit of meaningful information for investors. In order to ensure that such unlevered returns are presented on a transparent and comparable basis across funds, in lieu of a full statement, the Commission could seek to require disclosure of material assumptions made by the adviser in the calculation of such unlevered returns. In any event, any such requirement to present unlevered returns should be in addition to a presentation of levered returns and should be designed to capture the impact of the use of subscription lines in lieu of capital contributions, and not the impact of any leverage that is not used for such purpose (e.g., deal-level financing).

Finally, advisers generally use short-term subscription lines to manage cash flows and capital calls throughout the year, rather than to manage returns. Should the Commission ultimately require the presentation of a statement of contributions and distributions without the impact of fund-level subscription facilities, or the presentation of unlevered returns, the Commission should carve out from such disclosure requirement the impact of any short-term subscription line primarily used to manage capital calls.

(v) **Question:** The proposed rule would require only gross performance measures for the realized and unrealized portion of the illiquid fund's portfolio. Should the proposed rule require net performance information as well? Would net performance measures be beneficial for investors despite the drawbacks discussed above? What assumptions should we require in calculating net information? What limitations, if any, would advisers face in providing net performance measures?

Response: As an initial matter, investors in an illiquid fund generally do not request underlying performance measures for the realized and unrealized portions of the fund's portfolio because these components of performance do not present an accurate picture of a fund's aggregate performance before the end of the fund's life. These metrics are therefore of limited utility to investors in evaluating performance. Additionally, investors have their own methods for calculating IRR and other internal metrics, and advisers generally provide investors with information necessary for investors to conduct analyses under their existing metrics.

With respect to net performance, from an investor's perspective, gross and net performance is most informative for an entire portfolio because a comparison of gross vs. net performance accurately shows fees and expenses, many of which are fund-level expenses that are not specific to a particular investment. Providing gross and net figures for the realized and unrealized portions of a portfolio would therefore require the adviser to make subjective cost-allocation decisions for expenses that do not relate to a particular investment. Such data will thus be of limited utility because these figures will not show the performance of the entire portfolio (or of its realized and unrealized portion) in a meaningful way.

Providing net performance information would add complexity and require an adviser to take fund-level activities (such as expenses relating to leverage incurred at the fund level, compensation expenses, and others) and ascribe them not only to individual investments, but also to the realized and unrealized portions of investments. The adviser must necessarily base such an allocation on subjective estimates, as the Commission correctly notes in the Proposal. Disclosure of gross and net figures for the realized and unrealized portions of the portfolio would also require the adviser to make subjective decisions regarding what is considered "realized" and "unrealized," which is likely to result in differing definitions across funds or advisers. GAAP financial statements do not require detailed reporting of net performance information on a per-investment basis and a realized vs. unrealized basis as the Commission proposes. Requiring this level of detail will reduce the comparability of such information.

Thus, although we believe the presentation of gross unrealized and realized performance will not be meaningful to investors in illiquid funds, we agree that if the Commission does determine to adopt such a requirement, net realized and unrealized performance should not be required. It would be simpler for investors and less burdensome for advisers if the information were presented only as gross performance, as proposed.

We would also note that, for a fund of funds, breaking out realized vs. unrealized for performance purposes would be operationally challenging because an adviser to a fund of funds is unlikely to have access to sufficient information to present the required information. Any assumptions made to close this information gap will limit how meaningful the information is to an investor.

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

Response: We agree that the absence of standardized terms may reduce the comparability of information across funds, but defining the phrases as the Commission proposes will not cure the issue. Whether an investment or portion of a portfolio should be considered realized or unrealized depends upon an examination of the specific facts and circumstances. In the private fund context the analysis often hinges upon the contractual terms of the individual fund and its waterfall mechanics. Because there is no bright-line test to determine when an investment has been realized, adopting a definition that is not tied to the specific economic realities of the underlying asset would not provide consistent, clear disclosure to investors.

In place of rigid definitions or *de minimis* thresholds, the Commission should permit advisers to disclose the criteria they currently use for making these judgments. Such qualitative disclosure will enable investors to better understand the fund's definition of "realized" and "unrealized" portfolios, and increase the usefulness and comparability of the information across funds. The Commission should also refrain from imposing definitions that may conflict with an adviser's classification as realized vs. unrealized as applied under GAAP for the fund's audited financial statements.

(vii) **Question:** Should we require advisers to disclose the dollar amounts of the realized and unrealized portions of the portfolio? Should we also require advisers to disclose such amounts as percentages? For example, if the value of the realized portion of the portfolio is $250 million and the value of the unrealized portion is $750 million, should we require advisers to disclose those amounts, both as dollar values and percentages *(i.e.,* 25% ($250 million) of the illiquid fund's portfolio is realized, and 75% ($750 million) remains unrealized)?

Response: No. As stated above, the requirement as proposed is of questionable value to investors. These dollar amounts will be superfluous in reporting, will lengthen and clutter reporting unnecessarily, and will detract from the other information presented that is likely to be of greater use to investors.

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

Response: If the Commission decides to adopt this rule, it should not remove the "since inception" requirement for quarterly reports. The most useful quarterly performance information for an investor is information that provides insight into how the investor's returns are trending. Presenting inception-to-date returns on a regular basis allows investors to understand the improvement or deterioration of returns over the relevant period. Conversely, performance for each quarter of the current year or cumulative performance for the current year, in isolation does not provide investors with the relevant information needed to assess performance trends, particularly with illiquid funds that are designed for long-term hold periods.

In addition, although private equity funds begin delivering financial statements to investors once capital is called, performance is listed as "N/M" (not meaningful) or "N/A" (not applicable) for at least one to two years, as it is considered not to provide an accurate picture in the early stages of a closed-end fund, as this is the period in which the fund typically incurs significant costs in sourcing investments, and does not yet generate returns. Thus, as is typical in the industry, we urge that the Commission not require performance metrics until the fund has at least four quarters of operating results.

If the Commission adopts reporting requirements that apply since the inception of a fund, we urge the Commission to only require funds formed after the effective date of the rule to report since inception. Retroactive application of such a requirement would be not only inappropriate, but also operationally incredibly difficult, if not impossible in certain circumstances.

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

Response: Investment-level contribution and distribution information is not meaningful and likely to be overwhelmingly voluminous to an investor. The relevant contribution and distribution information for investors resides at the fund, not the investment, level. While for certain types of funds with a relatively small number of investments, tracking this level of detail on an investment-by-investment basis may be manageable, for funds with hundreds or even thousands of portfolio investments, the burden and cost of providing this information would be significant and disproportionate to the benefits to investors: fund investors do not make investment decisions based on the performance of individual investments, but rather, based on the performance of a fund's portfolio as a whole. Fund investors also do not make allocation decisions with respect to the fund's investments, and generally do not make investment decisions or redemption decisions throughout the life of an illiquid fund. Therefore, in the case of such funds, the quantity of information provided to investors is likely to be overwhelming and, ultimately, of little value.

The Commission should also consider that it is not always feasible to match contributions and distributions to each underlying investment. In managing cashflows, funds often use subscription lines (and sometimes portfolio-level leverage), and may be permitted to "recycle" returns received from certain investments (in which case the fund reinvests returns on the investors' behalf, rather than returning the funds to investors). Such transactions can make allocating contributions and distributions to portfolio investments difficult, if not impossible. Moreover, funds who have European waterfalls may not be tracking this information because it is not relevant to them.

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

Response: There are other regulatory, governing, and industry bodies, including ILPA and the CFA Institute's Global Investment Performance Standards (GIPS) that already provide guidance on performance reporting by private fund advisers and we do not think that the Commission should add additional and potentially conflicting guidance on top of what already exists. As discussed elsewhere, the final rule should permit advisers flexibility to provide performance metrics and explanations that it determines are most relevant to its investor base. More importantly, advisers should clearly describe the metrics they present and any methodologies and assumptions necessary to understand the effects on reported performance.

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

Response: Advisers should not be required to reflect taxes paid or withheld for specific investors in the fund-level performance metrics. While funds are obligated to withhold taxes on behalf of investors, it would be confusing for investors and a significant burden for advisers if the performance information was affected by an individual investor's tax profile. Such information is complex, specific to the investor, and not in the adviser's control. Reflecting performance net of taxes would also yield differing results for funds with differing investor bases and has the potential to distort performance information presented, without a corresponding benefit.

While not every sponsor uses blocker vehicles, the Commission should consider that, where utilized, a blocker vehicle exists for the administrative convenience of its individual investors. Making an investment through a blocker vehicle serves to reduce an investor's tax filing obligations (which are instead satisfied by the blocker) but not the investor's tax burden. Because not all investors in a fund invest through a blocker vehicle, excluding from performance metrics taxes paid by a blocker vehicle, but including taxes withheld by an unblocked fund on behalf of its investors, will reduce comparability across funds. This presentation would incorrectly skew performance information in favor of blocker vehicles, and in favor of funds who have a larger percentage of investors participating in blocked, rather than unblocked, vehicles.

(xii) **Question:** Should we require advisers to prepare and distribute statements to clients at least quarterly, or should we prescribe a different frequency? For example, should we require monthly, semi-annual, or annual statements? Should we mandate the same delivery frequency for all proposed statements under the rule? How would each of these approaches affect comparability and effectiveness of the information in those statements? Would a quarterly reporting obligation require advisers to value the fund's investments more frequently than advisers currently do?

Response: We note that the market practice is for private fund advisers to provide quarterly financial information to investors. In particular, providing this information on a more frequent basis for illiquid funds is not feasible because such funds generally close their books on a quarterly (not monthly) basis and perform valuations on a quarterly or annual basis. Changes in the value of a fund's investment (based on the most recent valuation) is one of the key metrics included in periodic financial reports. Monthly statements, therefore, would not provide useful information to investors as such statements would likely reflect stale data from the most recent quarterly or annual valuation the adviser performed.

The information provided in these reports typically is tailored to include the disclosures that the adviser considers most relevant to investors in that particular fund in light of its strategy, type of investments, liquidity profile, term, and other characteristics, and therefore it likely differs from the quarterly reports as set out in the Proposal. If quarterly reports meeting specified requirements are mandated, certain advisers may discontinue their current quarterly performance reporting practices. They will instead provide information solely in the Commission's prescribed format in order to avoid confusing investors with different disclosures contained in differing sets of quarterly reports. As a result, investors who have negotiated for disclosures that meet their information needs (either within the context of the fund's periodic investor reports, or by way of customized report for the specific investor) may no longer receive the desired information.

To mitigate these potential unintended consequences, if the Commission chooses to mandate that private fund advisers provide performance information in a prescribed format, it should be required on a less frequent basis.

We note further that, while the release states that the Commission would not consider "information in the quarterly statement required by the Proposal to be an 'advertisement' under the marketing rule," it appears that combining such information with other, non-mandated performance and other information could "convert" the communication into an "advertisement." Under the Proposal, however, simply using a subscription line would require an adviser to perform a hypothetical performance calculation for the private fund. As a result, combining the required statement information into a single communication that has other, non-hypothetical performance information that investors have come to expect based on the adviser's historical practices could trigger a requirement for the adviser to adopt hypothetical performance-related compliance policies and procedures that, for many advisers, would not otherwise be required. If the Commission chooses to adopt the Proposal as drafted, it should clarify that such combined reports would not constitute 'advertisements' under the marketing rule.

(xiii) **Question:** The proposed rule would require advisers to prepare and distribute a quarterly statement after the private fund has two full calendar quarters of operating results and continuously each calendar quarter thereafter. An adviser would be required to provide information for any stub periods that precede its first two full calendar quarters of operating results *(i.e.,* from the date of the fund's inception to the beginning of the first calendar quarter during which the fund begins to produce operating results). Should the proposed rule explicitly address how advisers should handle stub periods? If so, how?

Response: No, accounting practices with respect to stub periods already exist and advisers should be permitted to follow practices that most closely align with a fund's strategy. Prescriptive rules for stub periods are unnecessary and would further complicate already complicated requirements, with little to no benefit.

If the Commission requires such stub reporting, it should clarify that the starting point of such reporting may be as early as the adviser determines, but no later than the date that the fund makes its first investment or issues its first capital call, whichever is earlier.[1] This is generally consistent with the timing with which investors expect to receive financial statements.

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

Response: Distributing quarterly statements upon request would be more consistent with existing market practice. As noted above, most private fund advisers appreciate their investors' desire for transparency on fees, expenses and performance and will customize this information in light of an investor's requests. The additional burden of a standardized reporting format will not meet many investors' existing expectations and is unnecessary.

(xv) **Question:** Should we revise the definition of "distribute" expressly to include distribution by granting investors access to a virtual data room containing the quarterly statement? Why or why not?

Response: It is standard practice for advisers to distribute information to private fund investors via a virtual data room. We do not believe this practice requires explicit clarification in the rule. Any undercutting of this practice would delay investors' ability to access information, cause other administrative inconvenience for investors, have an adverse environmental impact and would increase reporting costs. Furthermore, such a departure from the current practice would be inconsistent with the SEC's efforts to facilitate electronic delivery of reports.

(xvi) **Question:** Do commenters agree that the proposed rule should require advisers to consolidate reporting to cover related funds to the extent doing so would provide more meaningful information to investors and would not be misleading?

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[1] When a related party warehouses an investment for a fund, the starting point of reporting should be the date on which the related party transfers the investment to the fund. "Warehousing" generally occurs where the sponsor identifies an investment appropriate for a fund before the fund is in a position to make an investment (for example, the fund may not have held a closing yet). In this case, a related entity may make the initial investment. Once the fund is in a position to make its own investments, it can then acquire the warehoused asset. Because the fund only owns the asset once this transfer from the related party has been completed, the investment will not be reflected on the fund's books until such time.

Alternatively, should we prohibit advisers from consolidating information for multiple funds? Why or why not? Should the rule permit, rather than require, consolidated reporting?

Response: Any reporting requirement should provide flexibility for a private fund adviser to use a consolidated or unconsolidated approach, as long as doing so would enable the adviser to provide all materially relevant information. The additional standard in the Proposal – requiring consolidation "[t]o the extent doing so would provide more meaningful information to the private fund's investors" – is vague and effectively requires a private fund adviser to "read the mind" of its investors – who may themselves have different perspectives on what is "more meaningful" or what is considered a "related fund" for any particular adviser. The variation in what different investors are likely to find "more meaningful" is, in fact, one of the reasons why attempting to standardize performance and fee and expense reporting across the entire private fund industry is unlikely to yield the primary result the Commission seeks, i.e., comparability. The need for such customization is also why such detailed reporting requests are often dealt with in negotiated side letters or on an informal basis.

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

Response: Please see the response above. In addition, the definition of "substantially similar pools of assets" is both vague and excessively broad. While it seems the Commission primarily intended to capture master-feeder or parallel structures that operate as a single complex through different vehicles having similar terms, liquidity structures, investments, etc., defining "substantially similar pools of assets" as funds having "substantially similar investment policies, objectives or strategies" could easily pick up, for example, other closed-end funds of different vintages within a broader fund family.

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

Response: The removal of the surprise exam option would have significant adverse consequences for many advisers. Failing to allow the surprise exam would be particularly problematic for certain advisers such as those that advise hundreds of special purpose vehicles ("SPVs") that are treated as clients. These include advisers with separately managed account clients that pool client assets into SPVs to make investments, or advisers that create a new vehicle for each investment. Other advisers use an auditor that is independent for AICPA purposes, but not independent as defined in the Proposal. The staff cites to no evidence that the surprise exam has been ineffective to date, or that an audit would have a meaningful effect on the valuation practices of advisers. The incremental costs that these advisers will incur to comply with the Audit Reform, costs which will most likely ultimately be borne by LPs, are significant and out of proportion with the speculative protection they will offer investors.

As a result of the surprise examination practice discussed above, the Proposal will cause a subset of SEC-registered investment advisers to operate at a disadvantage as compared to other market participants that conduct audits under the Custody Rule. The Proposal will likely impact the adviser's ability to compete for potential investments where auditor relationships with the potential investment target would not create the need for the other participant to either terminate its relationship with its auditor or cause a target company to terminate the relationship giving rise to the independence issue.

(xix) **Question:** Do commenters agree that the availability of accountants to perform services for purposes of the proposed audit rule is sufficient and that even advisers in foreign jurisdictions (or with private fund clients in foreign jurisdictions) would not have significant difficulty in finding a local accountant that is eligible to perform an audit under the proposed rule? Do advisers have reasonable access to independent public accountants that are registered with, and subject to inspection by, the PCAOB in the foreign jurisdictions in which they operate? If not, how should the rule address this issue?

Response: The AIC recognizes the value of audited financial statements to private fund investors. However, we believe that limiting the auditors that may perform audits of private funds under the Proposal to PCAOB-registered auditors may have unintended consequences.

First, numerous AIC members currently undergo audits conducted by auditors who are AICPA members, and meet the AICPA's standards of independence but either are not registered with the PCAOB or do not meet the standards of independence of Regulation S-X. For example, this may occur if an auditor performs certain functions for a fund portfolio company. The Proposal may force such advisers to switch auditors, even though the audit firm currently conducting their audits meets the AICPA's requirements and may have necessary expertise. The universe of auditors that satisfy the definition of "independence" as proposed by the Commission is limited. Any rule as adopted should permit auditors to meet the AICPA's standards of independence.

The most qualified and experienced auditors in the private equity space therefore may not meet the proposed independence standards. Potentially forcing an adviser to select an auditor that it does not believe has the requisite expertise for providing services to the fund could result in an audit that is of lesser quality and therefore harm LPs. LPs may also be harmed if advisers seek to resolve independence issues by other means that adversely affect the value of a fund's investments. For example, where an independence issue arises because of the auditor's relationship with a portfolio company, as is often the case, an adviser may seek to terminate the auditor's relationship with the portfolio company, even if that is not necessarily most beneficial to its investors. An adviser that operates in a foreign jurisdiction would experience even more difficulty than advisers in the U.S. would experience.

We also note that requiring a fund's independent auditor to be "registered with, and subject to inspection by, the PCAOB" could mislead investors by suggesting that the auditor's work related to that fund is subject to inspection by the PCAOB. Under the Sarbanes-Oxley Act, the PCAOB inspects registered audit firms in order to assess their compliance with certain laws, rules, and professional standards in connection with a firm's audit work *for public company* and *broker-dealer clients*.[2] Audit firms registered with the PCAOB are therefore not subject

[2] https://pcaobus.org/oversight/inspections, accessed on May 23, 2022.

to PCAOB inspections for other audit work they perform (such as auditing private funds and their nonpublic portfolio companies).

We would therefore encourage the Commission to adopt an amended version of the audit rule to permit AICPA-compliant auditors to conduct fund audits.

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

Response: The rule should provide the adviser with flexibility to address audits of stub periods that are in investors' best interests. For example, it generally would not benefit investors to absorb the costs of an audit for a fund in liquidation with one or two remaining assets, where the cost of the audit could exhaust all of the remaining assets and would serve little purpose. The Commission should similarly harmonize the Custody Rule's stub period treatment.

(xxi) **Question:** Are there other transactions for which we should require private fund advisers to obtain a fairness opinion? For example, should we require advisers to obtain a fairness opinion before certain cross transactions between private funds it manages? If so, which transactions? Should we provide certain cross transaction exemptions, such as exemptions for bridge financings or syndications where the selling fund transfers the investments within a short period at a price equal to cost plus interest?

Response: We do not believe other cross transactions, as with adviser-led secondary transactions, would benefit from a requirement to obtain a fairness opinion. Cross transactions are already subject to significant requirements under the Advisers Act, including in particular the adviser's compliance with its fiduciary duties and obligation to consider the best interest of its clients. Where appropriate, this will involve the making of appropriate disclosures to and obtaining consent from the advisory clients. The use of cross transactions is also very common among advisers for purposes of portfolio rebalancing, and it would be cost-prohibitive – and would make very little sense commercially – to obtain mechanistically a fairness opinion each time that investments are transferred between funds for routine, ordinary transactions. Rather than imposing an additional, costly requirement on advisers' use of cross transactions, the Commission should take comfort from the meaningful existing obligations and market practices around cross-transactions.

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

Response: Under the Advisers Act, private fund advisers are already subject to a fiduciary duty and an obligation to consider the best interest of its clients. We do not believe that a blanket prohibition would serve a useful purpose in such transactions, as they would only prohibit many transactions that are otherwise consistent with the adviser's fiduciary obligations. As part of their day-to-day management of private funds, private fund managers engage many service providers in the ordinary course of business; however, the extent of such engagements varies widely and in most instances such relationships do not give rise to material conflicts of interest. For example, a financial adviser could be engaged as a placement agent for a fund launched by an adviser, and two years later the same adviser could be considering a secondary transaction process for another fund. It would not make sense for that financial adviser to be automatically disqualified from acting as a fairness opinion provider for the secondary transaction. Creating a restriction on opinion provider engagements could require the adviser to retain a more expensive service provider, or a less well-positioned service provider, than it would have otherwise sought. Advisers may also need to maintain "opinion-only" relationships separate from its other service providers, which would limit advisers' ability to find the best opinion provider or create competition to reduce costs.

(xxiii) **Question:** Should we define, or provide additional guidance regarding, the phrase "initiated by the investment adviser or any of its related persons"? Should we define, or provide additional guidance regarding, the role the adviser would have to play in a secondary transaction for it to be considered an adviser-led transaction subject to the proposed rule?

Response: We agree with the Commission's view that whether the adviser or its related person has "initiated" a secondary transaction requires analysis of the particular facts and circumstances of the transaction. While a transaction may appear to have been initiated by the investment adviser or any of its related persons on its face, it is possible that the underlying motivation of such transaction originated primarily from third parties, such as an unsolicited request for a secondary sale from one of the investors or changes in applicable regulations. Such circumstances may not present the same types of conflicts.

(xxiv) **Question:** We recognize that certain adviser-led transactions may not involve investors rolling their interests into a new vehicle managed by the adviser. For example, an adviser may arrange for a new investor to offer to purchase fund interests directly from existing investors, such as a tender offer. Do commenters agree that the first prong of the definition would cover such transactions? Should the rule treat such transactions differently?

Response: The proposed rule defines "adviser-led transactions" as transactions initiated by the adviser or its related persons that offer fund investors the option to "sell all or a portion of their interests in the private fund" or "convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons." We believe that this definition would capture instances where an adviser arranges for a new investor to offer to purchase fund interests directly from the existing investors (e.g., a tender offer). In a tender offer scenario, we do not believe there is any value to a fairness opinion requirement as each fund investor has complete discretion to decide whether to remain in the fund on its original terms or sell its interest in the fund to the purchaser at the price offered. As such, we believe that tender offers, and other secondary transactions where a new vehicle managed by the same adviser or its related persons is not acting as the purchaser, would not benefit from a fairness opinion and that such transactions should be carved out from the definition.

(xxv) **Question:** Should the rule apply to adviser-led transactions initiated by the adviser or its related persons as proposed? Is the definition of "related person" too broad in this context such that it would capture secondary transactions initiated by third parties unrelated to the adviser? Should we revise the definition of "related person" to include an investment discretion requirement? Similarly, is the definition of "control" too broad in this context?

Response: We believe that the term "related person" is too broadly defined in the proposed rule. The proposed definition would inadvertently capture secondary transactions initiated by third parties that are not truly "related" to the adviser in a way that could present material conflicts of interest. For example, employees who are invested in a fund, but who have no investment discretion and do not receive a share of the management fee or carried interest of the fund, could seek out a secondary sale of his or her interests in the fund. Such transactions should not be covered by any requirement relating to true adviser-initiated secondary transactions. Instead, we believe the definition, if adopted, should more appropriately cover transactions initiated by the adviser or its related persons who have investment discretion over the relevant fund and have an economic interest in the management fee or carried interest generated by the fund or the new vehicle that will be the purchaser in the secondary transaction.

(xxvi) **Question:** Should the rule apply to all advisers as proposed? Alternatively, should the rule apply only to SEC-registered advisers? If so, why?

Response: We do not believe that these specific prohibitions on certain activities should be adopted by the Commission for the reasons discussed in more detail in the Comment. Non-SEC registered advisers, which include small or mid-sized advisers that do not meet the threshold for SEC registration, will likely be disproportionately affected given their limited resources relative to larger, registered advisers. Requiring exempt private fund advisers to comply with these sweeping, onerous and costly regulations would also be inconsistent with Congress's deliberate choice in Section 203 of the Advisers Act to exempt certain advisers from the major substantive provisions of the Advisers Act, including registration. If the Commission subjects private fund advisers exempt from registration to the substantive requirements set out in the Proposal, it will affirmatively be choosing to eliminate the distinction between registered and exempt investment advisers, in contravention of clear congressional intent.

(xxvii) **Question:** We have historically taken the position that most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients (including funds) of a registered offshore adviser.[3] In taking this approach, the

[3] *See, e.g., Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers,* Investment Advisers Act Release No. 3222 (June 22, 2011) [76 FR 39645 (July 6, 2011)]; Marketing Release, *supra* footnote 61, at n.199.

Commission noted that U.S. investors in an offshore fund generally would not expect the full protection of the U.S. securities laws and that U.S. investors may be precluded from an opportunity to invest in an offshore fund if their participation would result in full application of the Advisers Act and rules thereunder.[4] Similarly, the proposed prohibited activities rule would not apply to a registered offshore adviser's private funds organized outside of the United States, regardless of whether the private funds have U.S. investors. Do commenters agree that registered offshore advisers should not be subject to this rule with respect to their offshore private fund clients or offshore investors? Should other rules in this rulemaking package take the same approach, or a different approach, with respect to a registered offshore adviser's offshore private fund clients? Please explain.

Response: The Commission should apply its "registration lite" regime to non-U.S. investment advisers with respect to all of the rules in the Proposal. There is no legitimate legal or policy reason to do otherwise, and the Commission has not provided any legal, policy, or economic analysis to support a different approach.

(xxviii) **Question:** Instead of prohibiting these activities, should the rule prohibit these activities unless the adviser satisfies certain governance and other conditions *(e.g.,* disclosure to investors in all relevant funds/vehicles, approval by the limited partner advisory committee (or other similar body) or directors)? Should the rule prohibit these activities unless the adviser obtains approval for them by a majority (by number and/or in interest) of investors? Should the rule permit non pro-rata fee and expense allocations if such practice is disclosed to, and consented by, co-investors?

Response: Investment advisers are subject to existing statutory requirements and rules (e.g., Sections 206(1) and (2) of the Advisers Act) and follow market practices that, in the aggregate result in fulsome disclosures to investors. Additionally, many advisers also follow additional internal procedures that often mandate more than the Advisers Act and the rules promulgated thereunder. For example, advisers often seek investor consent for transactions even if consent is not explicitly required under the Act (e.g., for affiliated transactions not involving a Section 206(3) principal transaction) and often consult with or seek consent from investor committees. These practices address the concerns the Commission raises in the Proposal and should, in our view, already meet the governance conditions the Commission seems to be suggesting. In addition, a private fund's

4 *See Registration Under the Advisers Act of Certain Hedge Fund Advisers,* Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054, 72072 (Dec. 10, 2004)].

operating documents and offering documents address the activities that are listed in the proposed rule – for example, fund documents will often disclose the types of expenses that can be charged to the fund and allocation methodology, how the adviser clawback will be calculated, what the limitations on exculpation and indemnification of the adviser are, and whether principal transactions and other transactions between the fund and the adviser will be permitted (and in what circumstances). Requiring separate consent (let alone an outright prohibition) with respect to such activities would be unnecessary and duplicative. As long as there is sufficient disclosure in place, the Commission should not need to prescribe how sophisticated market participants can negotiate a set of terms on which they are willing to enter into an advisory relationship.

(xxix) **Question:** As noted above, if an adviser is paid in advance, and reasonably expects to perform services, but ultimately does not provide the contracted for services, the proposed rule would require the adviser to refund the prepaid amount attributable to the unperformed services. Do commenters agree with this approach? Why or why not?

Response: As noted above, an investment adviser may incur expenses and prepare to deliver a service that may not ultimately be required. For this reason, any rule should not require advisers to refund the prepaid amount attributable to unperformed services.

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

Response: Yes. Investors make investment decisions based on fund terms as disclosed in offering documents and set out in the fund's governing documents. An investor made aware of this practice through clear disclosure would have adequate notice of this practice (as it would all fund terms) and would make an informed investment decision based on this disclosure. As noted in the Comment, investors in private funds are sophisticated actors who decide whether to invest in a private fund based on the totality of the terms. For these reasons, any rule should not prohibit these expense practices if the adviser discloses the practice.

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

Response: As explained in the Comment, the Commission does not have the authority to require parties to agree to European waterfalls over American waterfalls. We moreover see no regulatory or policy reason to favor European-style waterfalls over American style waterfalls.

The return of all capital (or "European") waterfalls are less likely to result in adviser clawbacks, but this is only true because of the net of tax cap on clawbacks. The partnership tax rules on income allocations are not based on cashflows between a partnership and its partners but rather are based on the partnership's taxable income determined on a tax adjusted accrual basis (which may bear no correlation to the cashflows between a partnership and its partners at any given time). The rules do not distinguish between European or American waterfalls – in the former case, gain from any investment may be allocated to the adviser in respect of carried interest (thus generating taxable income for the adviser) even as the cash is diverted to the investors as return of capital. For this reason, European-style waterfalls generally provide for the adviser to receive tax distributions as a priority to the waterfall as an advance on future carried interest distributions. Accordingly, the U.S. and European waterfalls result in essentially the same tax results.

(xxxii) **Question:** What issues may advisers face in complying with this aspect of the proposed prohibited activities rule? In particular, what issues may result with respect to amending tax returns from prior years?

Response: Contrary to the Commission's suggestion, an adviser's investment professionals generally will not be able to amend prior year tax returns to recover excess taxes paid and offset them against losses incurred in later years. An investment professional would therefore not be able to recover tax payments made on carried interest distributions that were subsequently clawed back. Current tax law applicable to individual taxpayers does not permit losses incurred in later years to be retroactively applied against income earned in earlier years. Accordingly, while in theory tax policy would provide that any prior income allocated to an individual should be offset by losses in a later year in a clawback scenario, such losses often cannot be used in a clawback scenario. To utilize losses in the year of a clawback, the investment professional would generally need to have a corresponding amount of current year taxable income of the same character to offset, which is unlikely if the fund is in a clawback position.[5] The

5 Even if the investment professional has other income during the year (or a later tax period), offsetable losses may be limited under complex loss limitation rules and/or may not be utilizable due to the character of income and losses not aligning. Further, the tax laws of different states may vary with respect to a taxpayer's ability to claim losses for state tax purposes, further reducing the investment professional's ability to offset losses.

recognition that the tax rules on loss utilization significantly limit an investment professional from recouping tax overpayments from earlier periods is the primary reason why most investors in private equity funds do not insist on negotiating for tax benefits recognized from the payment of a clawback to be taken into account in the net after tax cap clawback. Even in those limited situations where tax benefits are taken into account, investors have recognized that taxes and tax benefits need to be determined based on hypothetical assumptions (determined by the advisers and disclosed to their investors) to avoid any invasive oversight of personal financial information of the adviser's employees.

(xxxiii) **Question:** We recognize that many fund agreements clawback performance-based compensation on a post-tax basis. We considered, but are not proposing, a rule that would generally allow this practice to continue, but would prohibit advisers from using a hypothetical marginal tax rate to determine the tax reduction amount.[6] We considered requiring advisers to use the actual marginal tax rates applicable to the adviser or its owners, rather than a hypothetical marginal tax rate. Our view is that this approach could be too burdensome for advisers. Do commenters agree? If we were to adopt this approach, how should we factor tax benefits realized by the adviser or its owners into the tax reduction amount? What operational challenges would advisers face under this alternative approach? For example, would the amount of time it may take to determine the actual tax amount, which may not be determined until a significant amount of time has passed not justify the benefits? Do commenters believe that the use of a hypothetical marginal tax rate is a reasonable and cost-effective method for determining the tax reduction amount, or do commenters believe that the hypothetical marginal tax rate is too high? Why or why not? Please provide data.

Response: We agree that providing for actual tax liabilities to be taken into account in determining the amount of any clawback would be impractical and too

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6 Because many entities that receive performance-based compensation are fiscally transparent for U.S. federal income tax purposes and thus not subject to entity-level taxes, determining the actual taxes paid on "excess" performance-based compensation can be challenging, particularly for larger advisers that have not only a significant number of participants that receive such compensation but also have participants subject to non-U.S. tax regimes. To address this problem, advisers typically use a "hypothetical marginal tax rate" to determine the tax reduction amount, which is usually based on the highest marginal U.S. federal, state, and local tax rates. Advisers argue that this approach is a reasonable and cost-effective method for determining the tax reduction amount; investors argue that the hypothetical rate is too high and therefore reduces the clawback amount to their detriment.

burdensome for advisers. As advisers are generally treated as partnerships for U.S. federal income tax purposes, determining actual marginal tax rates applicable to carried interest requires advisers to go through a burdensome exercise of reviewing the unique tax positions of each investment professional receiving carried interest. Moreover, this would create significant questions regarding how investors would properly audit an adviser's calculations in this regard while avoiding invasive oversight by investors of personal financial information of the adviser's investment professionals. Given that providing for actual tax liabilities is unduly burdensome, the only practicable alternative is the use of a hypothetical marginal tax rate. An outright prohibition on net of tax clawbacks would, as discussed above, be even more burdensome because it would require investment professionals to make clawback payments to a fund for amounts that they themselves paid to tax authorities and are often unlikely to recover. While any limitation on an adviser's ability to use a net of tax cap clawback is extremely problematic as discussed above, at a minimum, advisers should be free to cap a clawback based on actual tax liabilities.

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

Response: The transition period should in no event be less than two years after the rule's effective date. If the rule became effective today, it would be impossible for the private fund industry as a whole to hire, within one year, the amount of staff that would be needed to facilitate implementation, particularly given existing labor market shortages and the fact that many firms are still striving to reconfigure their operations in an economic and social environment upended by the ongoing consequences of the Covid-19 pandemic. In addition, even with adequate staffing, many firms will need to reconfigure their operations and infrastructure in order to become compliant with the Proposal as drafted. This may include renegotiating employment agreements to adjust the compensation of investment professionals, re-evaluating fee structures, re-configuring their financial reporting function (as well as the financial reporting function of countless portfolio companies, which likewise will have to adjust their practices), as well as identifying and negotiating insurance to cover heightened liability standards (to the extent such insurance becomes available). This will not only be extraordinarily costly, but will also require significant time to accomplish.

Most importantly, the rules should not be applied in respect of any private fund advisers or private funds – and in particular, any closed-end funds – that have admitted third-party investors prior to the date that any of the proposed rules become effective. Compliance with the terms of many partnership agreements and side letter provisions that exist today – including numerous market-standard terms – will violate the rules if they are adopted as proposed. Amending private fund documents, particularly for closed-end funds, generally will require investor approval, often a majority-in-interest of the limited partners but in some cases a supermajority (e.g., if an amendment will have an adverse effect on a particular investor or subset of investors) or even an individual investor. Private fund advisers and investors generally negotiate the terms of a private fund over a period of several months. Renegotiating and amending existing agreements, most likely for all active funds the adviser manages, will take significant time,[7] even if the adviser and investors are generally aligned. Because investors have already committed to the funds they will be asked to negotiate, and because private funds generally do not permit investors to withdraw from a fund, significant complexity may arise where the investor and adviser are no longer aligned. As a result, private fund advisers may be forced to violate existing contractual obligations in order to comply with the Commission's requirements, or to violate the Commission's requirements for an indeterminate amount of time while they seek to renegotiate existing amendments. Indeed, we believe many investors who have already invested in or committed to private funds that are currently in operation or fundraising status do not wish to bear the burden of having to renegotiate terms or to distract the private fund adviser with whom they have invested from its actual business of investing their capital.

[7] Note that not only advisers, but also many institutional investors, will find themselves in a position of having to renegotiate material terms in a significant number of fund documents at the same time. For example, an institutional investor that averages 10 private fund investments a year may find themselves needing to renegotiate 100 investments at once (given that most private funds have a term of 10 years or more). Negotiations may be especially complex where a fund's performance is below the investor's expectation, and may also lead the parties to revisit other provisions in the fund's operational documents, causing yet further complexity.