April 23, 2022

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

RE: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (SEC Release Nos. IA-5955; File No. S7-03-22)

Dear Ms. Countryman:

The undersigned organizations appreciate the opportunity to submit these comments to the Securities and Exchange Commission ("SEC") concerning the proposed rule entitled, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews* ("the Proposal").

As written, the undersigned organizations oppose the regulatory scheme drafted in the Proposal. The amendments to rules under the Investment Advisers Act offered in the Proposal fail to "examine the relevant data and articulate a satisfactory explanation" for why such changes are necessary. There is a lack of a "rational connection" between the SEC's fact-finding and the resultant prohibitions and restrictions drafted in the Proposal.

Initial Thoughts

As consumers face eroding purchasing power because of heightened inflation, investors and retirement savers need affordable alternative investment options that provide solid returns now more than ever. The undersigned groups favor more access to these options – both directly and indirectly – for all investors, and reducing the regulatory burden that cuts into investor return.

Unfortunately, the SEC's Proposal on private fund advisers presents an unprecedented array of expanded regulatory authority over private capital markets. This Proposal is another example of the Biden administration's attempt to overregulate in the name of investor protection. The amendments in this Proposal do little to help investors but instead impose exorbitant regulations and reporting requirements on the business operations of private markets.

The Proposal is drafted as if private fund investors are unsophisticated. In fact, most private fund investors are institutional, well-funded, and possess deep investment knowledge. The SEC even acknowledges in the Proposal that most private fund investors are high net worth individuals, "retirement plans, trusts, endowments, sovereign wealth funds, and insurance companies." The SEC should be focused on protecting retail investors, not investors that already possess vast resources and financial acumen to understand partnership agreements and conduct proper due diligence for potential investments.

Under the Biden administration the SEC has pursued policies that restrict retail investors' access to both public and private capital markets. By imposing more burdensome reporting requirements and prohibitions on certain private fund activities, investors will face higher costs to invest. At the same time, the SEC refuses to both reform the definition of "accredited investor" to allow more retail investors to participate in private capital markets, and streamline the process for companies to go public, making investments more accessible to retail investors. In fact, if reports are true that the SEC plans to raise the income and wealth thresholds for individuals and couples to qualify as "accredited investors," this would shut out more investors from private financing and could specifically restrict minorities from accessing alternative investment options.

The SEC has drafted a Proposal that assumes investors have performed no due diligence, possess no information on private funds, and need the agency to hold their hand to make investment decisions. **Chair Gary Gensler is continuing to pursue his paternalistic regulatory agenda that will only serve to increase costs and lower returns for institutional and retail investors, bar retail investor participation in private capital markets, and restrict access to alternative investment options.**

Length of Comment Period

Under Chair Gensler's leadership, the SEC has been reluctant to provide adequate time for commenters to provide feedback on complex rules. Only recently, and after public pressure from certain organizations, the SEC began offering more rules with comment periods beyond 30 days. However, the SEC refuses to budge beyond even 60 days for the most complex of rules. In the past, complex rules had comment periods that exceeded 120 days.

Lawmakers have vocalized their support for longer comment periods on the SEC's new rules. In 2019, Democrats asked the SEC to provide at least 120 days to comment for any rules that amended the Community Reinvestment Act. House Democrats and Republicans have also asked the SEC to extend

the comment period for the Proposal. **Both sides of the aisle support comment period lengths that are commensurate with the complexity of the rule.** The Proposal itself is highly complex and will largely transform the landscape of private funds. **Accordingly, the comment period for the Proposal should be extended beyond its current deadline.**

Benefits of Private Funds

The Chicago Booth Review found that leveraged buyouts increase productivity at target companies. According to the article, "[w]rit large, the study refutes the claim that private-equity profits rest entirely on financial engineering and zero-sum wealth transfers from other stakeholders. Buyouts also create social gains by raising productivity at acquired companies."

Moreover, employment expands "by 11% in buyouts of privately held firms."

There are also positive effects of private equity on county-level employment. One study found "a positive association between private equity investment and employment growth. Results indicate that for each $1 million in additional private equity investment, a little more than 1.3 new jobs are created."

During the 2008 financial crisis, private equity firms saved failed banks and turned them around, avoiding any further systemic deterioration in the banking sector. A new study conducted by Yale University in collaboration with the FDIC and Duke University found that out of 482 bank failures resolved between 2009 and 2014, private equity firms acquired 13% of them, "the equivalent of 24% of the assets held by failed banks." Had private equity not bought those firms, researchers calculated that "25 (5.5 percent) more of the banks that failed during this time would have been liquidated, and another 37 (8.1 percent) would have gone to a higher-cost bidder." According to the study, private equity-acquired failed bank branches were also less likely to close compared to other failed bank branch acquisitions. Additionally, private equity-acquired banks experienced "roughly 35 percent higher growth across different specifications, in branch-level deposits compared to other failed banks."

The study concluded "that PE acquisitions allowed the FDIC to reduce resolution costs by $3.63 billion," saving taxpayer dollars. Under the current regulatory structure private equity has been able to bring financial stability to the banking sector.

Hedge funds also provide investors with alternative investment options that are useful in today's economic environment. Reduced portfolio volatility risk and higher returns in an environment where stocks and bonds are

offering weaker returns are just a couple of examples of how hedge funds can benefit investors.

Alterations to the regulation of private funds as offered in the Proposal risk increasing the costs of investing in these alternatives and does nothing to promote greater investor inclusion in the funds.

Prohibited Activities

Via unilateral executive action, SEC is proposing to prohibit six activities for private fund advisers. **This is a grievous overreach of authority by the SEC.** Congress has not instructed the SEC to intervene in private partnership agreements between investors and private fund advisers. Moreover, the SEC is attempting to prohibit standard contractual provisions that investors want included in agreements. Instead of following its three-part mission, the SEC is implementing restrictions that do the exact opposite. The prohibitions fail to protect investors, disrupt private agreements, and push capital formation out of private funds.

The Proposal:

1. Prohibits after-tax clawbacks. This is unnecessary government intervention in private negotiations between advisers and investors on how to use clawbacks to pay taxes on performance-based compensation. **There is no reason that the SEC needs to swoop in and "protect" institutional investors that have the wherewithal to understand the terms of the partnership agreements they are signing.** The decisions about excess performance compensation are an agreement between private parties—it should remain that way.

   The SEC claims that clawbacks currently put private fund advisers ahead of investors and that the Proposal will "foster greater alignment of interest between advisers and investors by prohibiting advisers from unfairly causing investors to bear these tax costs associated with the payment, distribution, or allocation of 'excess' performance-based compensation." This is not true because the assumptions and calculations made by the SEC misrepresent how advisers take tax liabilities into consideration when determining the amount of the clawback.

   Moreover, the inability to offset taxes with clawbacks will most certainly increase costs for investors elsewhere. So, the benefit to investors of receiving the "pre-tax" amount is offset by increases in other fees, zeroing out any net benefit.

2. Prohibits "an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund." Investors conduct due diligence and voluntarily entered into partnership agreements with these certain provisions. **There is no reason the SEC should be determining certain terms for an agreement between private parties.**

   Additionally, the Proposal conflicts with the Investment Company Act. Under current statute, a retail investor may not indemnify an investment adviser for gross negligence but may indemnify the investment adviser for ordinary negligence. Under the Proposal, sophisticated institutional investors, who have deep knowledge and wherewithal to understand and comprehend contractual agreements, are forbidden to indemnify private fund advisers for even ordinary negligence. **This prohibition is clear overregulation that Congress has not instructed the SEC to pursue.**

   This prohibition would also lower returns for investors because sponsors would have less freedom to take greater investment risk. **Pension funds, which rely on higher returns from private equity, would be particularly harmed by restricting limitation of liability.**

3. Prohibits "an investment adviser from charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment." This infringes on how advisers can charge fees for certain services. The SEC would get to determine what constitutes a service that has been performed and is acceptable to receive compensation for such services. The SEC is telling advisers which fees they can charge and which they cannot. This is an unprecedented encroachment on private funds being able to make their own business decisions and negotiate agreements between private parties. This prohibition will also bar smaller funds from being able to diversify their options to offset expenses. It will also force investors to pay for expenses through other types of fees or products that investors may find to be undesirable and not worth their investment. This would push capital out of private funds and harm yields for pensions funds and endowments.

4. Prohibits "an adviser from charging a private fund for (i) fees and expenses associated with an examination or investigation of the

adviser or its related persons by any governmental or regulatory authority, and (ii) regulatory or compliance fees and expenses of the adviser or its related persons, even where such fees and expenses are otherwise disclosed." This shows favoritism for certain business models over others. It effectively prohibits the pass-through expense model. The SEC is picking winners and losers in the market for private fund investment. **Government should not be in the business of propping up certain business models over others.**

5. Bans non-pro rata distribution of fees and expenses. This is further unnecessary SEC interference in private contract negotiations.

6. Prohibits an adviser from loaning money from a fund's client. While preventing conflict of interest is important, this restriction fails to consider a situation in which a client volunteers to loan money to an adviser.

Fees, Expenses, and Compensation

One of the primary flaws of the Proposal is that it ignores how costly the new disclosures and restrictions on fees and expenses will be for investors.

Under the Proposal the SEC is dictating what it believes to be appropriate fees and expenses that private fund advisers should charge investors. The SEC is also skeptical of fees and expenses that may not be transparent enough for investors (e.g., consulting fees, monitoring fees, servicing fees, transaction fees, director's fees). The Proposal says the partnership agreements are vague and give advisers too much leeway in determining what fees will be applied. Financial management professionals in charge of managing a pension fund or endowment fund should already have the expertise to understand the degree of flexibility an agreement may provide the adviser. The investors should understand the risk before signing the agreement.

The SEC is also weighing whether to apply caps on fees and expenses that funds can charge investors. Caps would be a drastic overreach by the federal government and should not be considered at all. Private fund investors are sophisticated and perform extensive due diligence before investing in private funds. Capping fees would also not reduce overall costs for investors. Costs would shift to some other form, negating any putative benefits associated with a fee cap.

The Proposal wants advisers to disclose compensation and expenses before ***and*** after "offsets, rebates, or waivers." The benefit to requiring disclosure before offsets is negligible considering that the fee after the offset is the

actual fee investors would pay. The Proposal also wants advisers to document in writing the annual review of their compliance policies. This obviously benefits the SEC when it wants to keep tabs on private fund advisers, but it remains to be seen how this directly benefits investors and maximizes returns.

Preparation and Distribution of Quarterly Statements

The mandated quarterly statements required under rule 211(h)(1)-2 are unnecessary because institutional investors conduct extensive due diligence prior to investing in a fund and it will cost advisers hundreds of millions of dollars in compliance costs. Advisers also only have 45 days after calendar quarters to distribute quarterly reports. The detailed information that the SEC is requiring will certainly increase compliance costs for private funds and increase investment costs for investors. Not to mention, this new requirement will be exceedingly difficult for smaller sponsors to comply with, increasing their costs and potentially crowding them out from providing services entirely.

Recordkeeping for Quarterly Statements

The Proposal's recordkeeping requirements provide no direct benefit to investors. It requires expensive preservation of sensitive data of investors and retainment of "all records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any quarterly statement delivered pursuant to the proposed quarterly statement rule." Advisers would also be "required to make and keep books and records substantiating the adviser's determination that the private fund it manages is a liquid fund or an illiquid fund pursuant to the proposed quarterly statement rule." The recordkeeping requirements do little to benefit investors, but risk exposing proprietary data to hackers if the SEC were to be breached. Cyberattacks are an existential threat now more than ever as Russia retaliates against sanctions.

Privacy Concerns

The detailed disclosure information on investors into the private funds raises serious concerns of how the SEC will handle and store the data. The SEC was hacked as recently as 2017. If this happened again, it could expose certain private information of investors.

The Proposal requires disclosure of detailed information on private fund investors. For example, it would "require the fund table to show a detailed accounting of all adviser compensation during the reporting period, with separate line items for each category of allocation or payment reflecting the

total dollar amount." A cyber breach could expose proprietary compensation information.

The Proposal admits that calculating and recording ownership percentages for every portfolio investment would be onerous. This would be an onerous endeavor and could require more expenses for compliance which in and of itself could lower returns for investors.

Dates, names, and addresses of investors that the SEC has access to is a severe concern for protection of personal privacy.

The requirement to provide written documentation for every annual review of compliance and procedures will require advisers to hire more compliance assistance and would need to be paid for by investors in the private funds. This will increase expenses and fees on investors, creating the exact opposite effect of what the SEC is trying to accomplish. The SEC is also allowed to demand the written documentation "upon request," which could mean that advisers will be given no preparation time and will have to produce the documentation in an unreasonably quick timeframe.

Performance

The Proposal wants standardized performance metrics baked into the quarterly reports. It requires the performance reporting based on whether the fund is liquid or illiquid. While there might be a case to be made for the publicly traded assets to be more visible to investors under the aegis of the SEC, extensive reporting on private and alternative assets that are not traded over exchanges is a significant divergence from the SEC's traditional authority.

Liquid Funds

The Proposal requires retroactive reporting for liquid funds. Specifically, the requirement of reporting annual net total returns for every year since the inception of the fund is ludicrous. Coupled with the reporting of "the liquid fund's average annual net total returns over the one-, five-, and ten- calendar year periods" is duplicative and unnecessary for investors to make proper investment decisions.

Illiquid Funds

The SEC is intent on excluding subscription lines from key metrics that would be reported in the quarterly reports. However, it makes no sense to exclude a key financing element of the fund that would give investors an overall picture of the funds. The SEC is opposed to any recognition of

subscription lines, when in fact they are a prime factor in making an investment decision.

The Proposal requires advisers to report "[g]ross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio." It remains to be seen how reporting unrealized portions of the fund would benefit investors.

The SEC is further requiring "an adviser to disclose the illiquid fund's performance measures since inception." This kind of disclosure can be negotiated between private parties, and the SEC should not be in the business of mandating this type of information.

The SEC admits that illiquid funds will likely not have the appropriate information needed for quarterly statements. The Proposal states that they "may need information from portfolio investments and other third parties to generate performance data and thus may not have the necessary information prior to the distribution of the quarterly statement." This calls into questions the need to report on a quarterly basis for illiquid funds.

Certain fund level performance metrics should only be disclosed on a voluntary basis. If an investor requests the fund for more information, the adviser should furnish the information for the investor. Government-mandated disclosure for metrics such as gross IRR, MOIC, and unrealized portions of the fund's portfolio is unnecessarily burdensome to collect and collate. Some investors are more active than other investors and may want more information than others. However, that does not mean that every fund should be required to provide every piece of data for every investor. A more appropriate method for disclosure would be on a case-by-case basis for each investor. Discussions among the advisers, investors, and any third parties can decide on a voluntary basis whether to disclose certain information.

Mandatory Private Fund Adviser Audits

The Proposal unnecessarily imposes new mandates that the current "custody rule" structure does not. The custody rule provides advisers with more flexibility on how to comply with transparency requirements. The "proposed audit rule would not have a similar choice." Instead, advisers would be compelled under the new rule to "obtain an audit."

Moreover, the Proposal requires any independent auditor to receive regular inspection from the Public Company Accounting Oversight Board (PCAOB). As the SEC points out, this limits the number of accountants available to perform audits and the lack of "competition for these services might increase costs to investment advisers and investors."

The SEC is requiring private funds to disclose information that has no direct benefit to investors. It would collect auditor information and store it until it is needed to conduct punitive action on private fund advisers. The annual audit assumes that the private fund adviser is a malefactor. Under the Proposal, advisers are guilty until proven innocent.

Adviser-Led Secondaries

Unnecessary regulatory mandates such as requiring a private fund adviser to obtain a fairness opinion prior to conducting a secondary transaction with an investor infringes on the private agreement between the adviser and investor. The SEC proposes to "prohibit an adviser from completing an adviser-led secondary transaction with respect to any private fund, unless the adviser distributes to investors in the private fund, prior to the closing of the transaction, a fairness opinion from an independent opinion provider and a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider." Requiring advisers to obtain in writing an opinion on whether a secondary transaction price is "fair" goes beyond the SEC's authority and conflicts with previous SEC interpretation that "the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."

This change to adviser-led secondaries could diminish returns for investors. Normally, investors get longer exposure or alternative investment options with higher returns through adviser-led secondaries. The cost of the new fairness opinion could upend these alternatives. The cost associated with conducting this fairness opinion and the uncertainty of what defines an excess fee calls into question how effective this provision would be for protecting investors' interests.

Preferential Treatment

The proposed restrictions on side letter agreements for registered and non-registered private fund advisers is a heinous intrusion of government authority that threatens to reduce the amount of capital invested in private funds. If these restrictions are adopted, expenses and fees for all investors could increase and thus reduce returns.

No preferential contractual agreements should be required for certain investors and not others. However, the SEC has pointed out that certain side deals that increase assets in funds do provide benefits to other investors that may have not been possible if the private fund adviser was prohibited from negotiating side agreements. This can also spread costs over a larger investor base.

Requirements in the Proposal could be used by the SEC to pursue punitive action against advisers if they provide certain preferential treatment to investors that allows them to avoid ESG investments. The Proposal outlines a scenario in which an adviser might use an "excuse right" "to avoid investment in portfolio companies that do not meet certain environmental, social, or governance standards." Conversely, the SEC could use these disclosures as proposed to observe if an adviser is trying to allow investors to avoid ESG investments. If the SEC views the restriction to ESG investing as problematic, then advisers could potentially be punished for avoiding the agency's preferred socially responsible investments even if returns are lower than non-ESG investments.

Proposal's Economic Analysis

The economic analysis presented in the Proposal is arbitrary and capricious because it fails to appropriately validate the SEC's justification for amendments to the Investment Advisers Act.

The Proposal is void of any true comparison between the benefits and costs of imposing the new regulations. Multiple times, the SEC admits it lacks concrete data to conduct a thorough economic analysis. There is a lack of data to prove whether quarterly statements would benefit investors. The Proposal goes on to say that even if that data was available, "it would be difficult to quantify how receiving such information from advisers may change investor behavior." The SEC also admits it does not possess adequate data to determine the benefits of requiring a fairness opinion for adviser-led secondaries. The Proposal clearly states that "there is a lack of quantitative data on the extent to which adviser-led secondaries without fairness opinions differ in fairness of price from adviser-led secondaries with fairness opinions attached."

Additionally, the SEC admits in the Proposal that it cannot adequately determine how costly the implementation of the litany of prohibited activities would be for private fund advisers. The SEC also has no way to determine the benefits of imposing such restrictions because there is "a lack of data regarding how and to what extent the changed business practices of advisers would affect investors, and how advisers may change their behavior in response to these prohibitions."

Clearly, the SEC has failed to conduct a comprehensive analysis of the Proposal's economic impact. Failure to determine costs and benefits based on quantitative analysis runs afoul of SEC guidelines and court precedent, thus making this rulemaking arbitrary and capricious.

The SEC's analysis also states that certain restrictions and prohibitions in the Proposal would not harm small firms. The SEC does not believe any of

the exempt reporting advisers are "small entities" that would be affected by the prohibited activities rule and the preferential treatment rule. However, the SEC provides no explanation as to why that might be the case. It is hard to believe that the Proposal's drastic increase in compliance costs and restrictions on specific activities would not adversely affect smaller sponsors.

Concluding Thoughts

The Proposal is an extensive regulatory shift that prioritizes government intervention over free market negotiations between private parties. Instead of sticking to its mission "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation," the SEC has decided to give unneeded protection to only wealthy and institutional investors; introduce prohibitions that destabilize the financial landscape of private funds; and restrict capital formation by raising the cost of investing in private funds.

If the SEC proceeds to a final rule with the same conclusions and analysis produced in the Proposal, it will violate the guidelines and procedures codified in the Administrative Procedure Act and be deemed arbitrary and capricious.

We appreciate the opportunity to comment on the Proposal. If you have any questions, please contact Bryan Bashur at bbashur@atr.org.

Sincerely,

Americans for Tax Reform
FreedomWorks Foundation
Taxpayers Protection Alliance
Center for Individual Freedom
American Commitment
Heritage Action
Citizens Against Government Waste
Open Competition Center
Shareholder Advocacy Forum
Center for Freedom and Prosperity
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