April 15, 2022

Via Electronic Mail

Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, File No. S7-03-22

Dear Ms. Countryman:

The Healthy Markets Association[1] writes to offer comments on the Commission's above-referenced proposal to better protect investors, as well as promote transparency and market efficiencies in the private fund markets ("Proposal").[2]

We offer support for, and some recommendations regarding, each of the key elements of the Proposal:

- Requiring quarterly statements that include standardized, comparable, reliable, performance, fees, and expense information;
- Requiring audits designed to ensure the integrity of the valuation processes, as well as the performance, fee, and expense information;
- Prohibiting advisor-led secondaries unless the adviser obtains and shares a fairness opinion and a summary of its relationship with the provider of that opinion;
- Prohibiting certain activities, such as collecting fees for services not performed or barring claims from investors for gross negligence by the investment adviser; and
- Prohibiting some forms of preferential treatment, while requiring detailed disclosure of others.

As described in detail below, we urge the Commission to revise and adopt the Proposal without delay.

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[1] Healthy Markets Association ("HMA") is a not-for-profit member organization of public pension funds, investment advisers, broker-dealers, exchanges, and market data firms focused on reducing conflicts of interest and improving the transparency, efficiency, and fairness of the capital markets. As a result, HMA members would be directly impacted by the Proposal. To learn more about HMA or our members, please see our website at http://healthymarkets.org/about.

[2] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, SEC, 86 Fed. Reg. 16886 (Mar. 24, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf ("Proposal").

Background

In recent years, the number and value of private funds has grown, as has the complexity of private fund offerings. Many institutional investors, including public pension funds, endowments, and others, have significantly increased their allocations to private funds, including venture capital funds and private equity funds, in part driven by returns that have historically exceeded those available in most public market strategies.

At the same time, there is a significant difference between the investor protections and market safeguards for public funds, versus private funds.

While the federal regulatory regime demands significant public disclosures by registered investment companies about their governance, operations, and financials, the same requirements do not generally apply to so-called "private" funds. Similarly, the federal securities laws and Commission rules impose a number of restrictions on transactions and activities of registered investment companies that do not generally apply to private funds.

The Proposal seeks to reduce this gap in investor protections between public and private funds by essentially requiring greater information from, as well as prohibiting some activities by, private funds.

The need for the private fund reforms detailed in the Proposal are already well-documented by the Commission and its staff.

For example, in 2014, the Director of the then-Office of Compliance, Inspections, and Examinations outlined the staff's findings from examinations of the private equity industry. Stunningly, Director Bowden asserted that his team "examined how fees and expenses are handled by advisers to private equity funds, [and] identified what we believe are violations of law or material weaknesses in controls over 50% of the time."[3]

But fee and expense practices were only a small fraction of the problems identified by the Commission staff's review of private equity fund practices. While some investment adviser conflicts of interest are obvious, such as investment adviser's temptations to over-value less-liquid fund assets and collect fees on them, others are not. As Director Bowden explained,

> With this control and the relative paucity of disclosure required of privately held companies, a private equity adviser is faced with temptations and conflicts with which most other advisers do not contend. For example, the private equity adviser can instruct a portfolio company it controls to hire the adviser, or an affiliate, or a preferred third party, to provide

[3] Remarks of Andrew J. Bowden, SEC, May 6, 2014, *available at* https://www.sec.gov/news/speech/2014--spch05062014ab.html.

> certain services and to set the terms of the engagement, including the price to be paid for the services ... or to instruct the company to pay certain of the adviser's bills or to reimburse the adviser for certain expenses incurred in managing its investment in the company ... or to instruct the company to add to its payroll all of the adviser's employees who manage the investment.[4]

Unfortunately, the Commission staff identified instances where advisers had plainly given in to these temptations.

More recently, in January 2022, the Division on Examinations released a Risk Alert that identified an alarming number of significant failures and abuses by advisers to private funds,[5] including fund advisers:

- presenting track records that did not accurately reflect fees and expenses;[6]
- not calculating the fund-level management fee during a private fund's Post-Commitment Period in the way disclosed to investors, which "resulted in investors paying more in management fees than they were required to pay under the terms of the fund disclosures;"[7]
- not reducing the cost basis of an investment (or not doing so consistently) when calculating their management fee after selling, writing off, writing down or otherwise disposing of a portion of an investment, which could result in charging investors excess management fees;[8]
- extending the terms of funds without obtaining the approvals or complying with the liquidation provisions described in partnership agreements, which could result in charging investors excess management fees;[9]

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[4] Andrew J. Bowden.
[5] Observations from Examinations of Private Fund Advisers, Division on Examinations, SEC, Jan. 27, 2022, available at https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf ("2022 Risk Alert").
[6] *Id.*, at 4.
[7] *Id.*, at 3.
[8] *Id.*
[9] *Id*. Notably, this issue was raised in 2014, when the Director of the Office of Compliance, Inspections, and Examinations explained that some private fund advisers "continue to manage legacy funds long past their expected life. These managers are incentivized to continue to profit from their current portfolio even though that may not be in the best interest of investors. These managers may increase their monitoring fees, shift more expenses to their funds or try to push the envelope in their marketing material by increasing their interim valuations, sometimes inappropriately and without proper disclosure." Andrew J. Bowden.

- not accurately describing their funds' "recycling" practices, which may lead to charging investors excess management fees;[10]
- presenting stale performance information;[11]
- using data from incorrect time periods, mischaracterizing return of capital distributions as dividends from portfolio companies, using projected performance (rather than actual performance) in their track records;[12]
- omitting material facts about predecessor performance, including marketing incomplete prior track records or advertising performance of prior funds managed by people who weren't primarily responsible for the current funds;[13]
- cherry-picking the track record of one fund or a subset of funds;[14]
- exceeding leverage limitations outlined in fund disclosures,[15]
- failing to disclose the impact of leverage on fund performance;[16] and
- using investment strategies that diverged materially from their disclosures.[17]

These failures and others are often able to persist due to the often limited and inconsistent disclosures provided to investors by private funds and their advisers.

Quarterly Statements

There is no federal regulatory requirement for investment advisers offering private funds to provide their investors with regular statements.[18]

Some private fund advisers currently provide statements to investors, while others do not.[19] Periodic statements (which are often monthly or quarterly) may be provided to some investors, and information provided in some statements may not be provided to others. Further, to the extent some investors receive information, it may not be prepared in a standardized, consistent, comparable, or reliable way.

Often, the frequency, content, and quality of disclosures is subject to negotiation between investors and their private fund advisers. As a result, larger, more

[10] 2022 Risk Alert, at 3.
[11] *Id.*, at 4.
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*, at 3.
[16] *Id.*, at 4.
[17] *Id.*
[18] Proposal, at 16890.
[19] *Id.*

sophisticated investors often receive the most useful information in a timely manner, while smaller, less sophisticated investors often receive less timely and complete information. In part because the information provided to investors is often different, individual investors are typically unable to reconcile fund holdings, valuations, performance, fees, and expenses against what is contained in their limited partnership agreements or side letters. They are also unable to compare their different private fund investments.

The Proposal would ensure that all investors have essential information about private funds by requiring investment advisers to provide all investors with a

> quarterly statement that includes certain information regarding fees, expenses, and performance for any private fund that it advises and distributes the quarterly statement to the private fund's investors within 45 days after each calendar quarter end, unless a quarterly statement that complies with the proposed rule is prepared and distributed by another person.[20]

The Proposal would ensure that all investors in private funds are provided with essential information about their investments. Further, even investors who currently receive monthly or quarterly reports would benefit from the enhanced policies, procedures, and practices developed to ensure the quality and consistency of the mandatory disclosures.

A lack of detailed information often means that even large investors may be unable to identify and track their associated fees and expenses. For example, Bloomberg recently sent Freedom of Information Act requests to twenty-seven U.S. public pension plans seeking details on their expenses for their private fund investments.[21] Only one-third of the funds said that they track the actual "total costs" of their private equity portfolios, and only two of the public pension plans "said they monitored the expenses across categories."[22] One of the primary challenges for investors seeking to track this information is that they often are unable to obtain it from their advisers.

We note that "partner-level" information on a regular basis is essential for many investors, and is commonly provided. However, there is a non-trivial risk that some investment advisers to private funds may seek to rely on the new quarterly statements as a "ceiling" for disclosures,[23] which could inadvertently lead to less provision of

[20] Proposal, at 16890.
[21] Sabrina Willmer, *Private Equity's Opaque Costs Mystify the Pensions That Pay Them*, Bloomberg, Mar. 29, 2022, *available at* https://www.bloomberg.com/news/articles/2022-03-29/private-equity-firm-fees-create-headache-for-pension-plans.
[22] *Id.*
[23] For example, following the Commission's adoption of revisions to Rule 606 of Regulation NMS, some brokers who had previously provided greater details to their investor clients determined to rely upon the new "standard," and discontinued providing additional insights.

essential information to investors. Accordingly, we urge the Commission to require investor-level data to each investor. If this is deemed to be potentially too burdensome for some smaller advisers, we urge the Commission to at least consider this requirement for all fund advisers with greater than $1 billion in assets under management.

To the extent that there are different industry practices and standards for reporting performance, we urge the Commission to require compliance with an industry standard that it has approved as sufficient for purpose. Put simply, the Commission should mandate standardization, and work with investors and investment advisers to ensure the contours of that standardization.

Lastly, we do not believe the Commission needs to address discrepancies between disclosures made by funds under the current practices and under those put forth in the Proposal.

The content of potential quarterly disclosures should include all essential information about the fund, including its holdings, valuations, performance, and fee and expense information. It should also include that information in a manner that is specific to that particular investor. All of that is essential for having an accurate understanding of the fund, its risks, its performance, and its fees for all investors.

Mandatory Audits

The Proposal would “require private fund advisers to obtain an annual audit of the financial statements of the private funds they manage.”[24] The audit would have to be performed by an “independent public accountant” and financial statements would have to be “prepared in accordance with U.S. Generally Accepted Accounting Principles.”[25]

Of course, audits would protect investors against misappropriation of their assets, which the SEC has long recognized.[26] But regular audits are extremely valuable to all investors in private funds, however, because a truly independent audit “by an independent public accountant would provide an important check on the adviser’s valuation of private fund assets, which often serve as the basis for the calculation of the adviser’s fees.”[27] An independent check on the valuation methodologies, practices, and outcomes is essential to assessing not just a fund’s performance, but also its fees. A private fund’s adviser is often incentivized to exercise its discretion in favor of assessing potentially higher values to a fund’s illiquid investments, as the fund’s fees are often directly tied to those valuations.

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[24] Proposal, at 16911.
[25] *Id.*
[26] See *Custody of Funds or Securities of Clients by Investment Advisers*, SEC, 68 Fed. Reg. 56692 (Oct. 1, 2003).
[27] Proposal, at 16911.

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Because fund asset valuations are not just essential for fund performance and investor risk assessments, but also the determinations of fees and expenses, for registered investment companies, the Commission has long established fund valuation rules, which are designed to ensure that those funds' practices are designed to accurately reflect the true values of the holdings.[28] The Commission's rules for registered investment companies require funds to "market value of their portfolio securities when market quotations are 'readily available,' and, when a market quotation for a portfolio security is not readily available or if the investment is not a security, by using the investment's fair value, as determined in good faith."[29]

In December 2020, the Commission revised those rules to reflect the role of designated staff focused on performance of valuation responsibilities and reduce the dependency upon the board of directors in making good faith determinations. However, under that final rule, "fair value as determined in good faith will require assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; and overseeing and evaluating any pricing services used."[30] As the Commission's enforcement actions can establish, robust processes regarding the valuation of fund assets is essential.[31]

Unlike for registered investment companies, the Commission's "fair value" rules do not specifically protect private fund investors – even though many holdings in private funds are typically far less liquid than holdings of registered investment companies. The risk of intentional or unintentional mis-valuation is often significantly greater for private funds. At the same time, the fee and expense structures for many private funds often provide even greater incentives for potential over-valuations. So while the valuation risks and incentives are skewed more heavily against investors in private funds, the protections are qualitatively lower.

Absent a comprehensive fair valuation rule akin to what is required for registered investment companies, at a bare minimum, the Commission should require private fund

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[28] See *Good Faith Determinations of Fair Value*, SEC, 86 Fed. Reg. 748, 784 (Jan. 6, 2021), *available at* https://www.govinfo.gov/content/pkg/FR-2021-01-06/pdf/2020-26971.pdf ("[P]proper valuation promotes the purchase and sale of fund shares at fair prices, and helps to avoid dilution of shareholder interests. Furthermore, investors may have stronger assurance that they can rely on valuations to express the risk and return profile of a fund, making investors' decisions better informed. Thus, investors may be better able to evaluate a fund and consider whether a fund fits into their investment goals in terms of returns and risk (e.g., ability and willingness to bear risk). Improper valuation can cause investors to pay fees that are too high or to base their investment decisions on inaccurate information.") ("Fair Value Rule Revision").

[29] *Id.,* at 748.

[30] *Id.*, at 749.

[31] *See, e.g.*, *SEC v. James Velissaris*,1:22-CV-01346, (S.D.N.Y. Feb. 17, 2022), *complaint available at* https://www.sec.gov/litigation/complaints/2022/comp-pr2022-29.pdf (alleging "Velissaris was … actively manipulating the valuation models available from the Pricing Service and altering inputs to mask the poor performance of the Infinity Q Funds. This allowed him to attract investor funds, keep investors from redeeming their investments, and enrich himself through performance and management fees.").

processes related to valuations, performance, fees, and expenses to be audited, as well as require fund financial statements to be prepared in accordance with GAAP.

Some commenters have asserted that since voluntary audits are common for private funds, that there is no need for a mandatory audit requirement.[32] Further, some argue that since the rate of private funds making these voluntary audits is actually declining, investors may not value such audits.[33] These claims misconstrue market dynamics impacting private fund investors.

Many institutional private fund investors, such as public pension funds, have pre-determined investment allocations to alternative investment strategies.[34] As allocations to private fund investments have generally risen in recent years, investors have faced increased competition to participate in investment vehicles offered by leading advisers or specific attractive opportunities.[35] In fact, as this competition for the opportunity to invest has increased, many institutional investors have been compelled to lower their demands upon private fund advisers, including accepting even egregious, anti-investor contractual provisions, such as purported waivers of liability.[36]

Much like would-be home purchasers waiving inspection clauses when buying homes in a "hot market," pension funds, endowments, and other institutional investors have been forced to accept lower protections (and greater risks) if they want to make investments in private funds. Given that many of these investors have obligations to seek aggressive long term performance targets, the lack of mandatory audit requirements means that many are forced to decide whether demanding an audit is worth missing out on a potentially high performing investment.

The fact that competitive pressures have led investors to participate in private funds without audits is a market failure. Investors' decision to invest in a private fund without

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[32] *See, e.g.*, Letter from Professors Steven Utke and Paul Mason, to Vanessa Countryman, SEC , Feb. 26, 2022, *available at* https://www.sec.gov/comments/s7-03-22/s70322-20117881-270805.pdf.

[33] *See, e.g.*, *Id.*

[34] *See, e.g.*, Press Release, *CalPERS Board Selects New Asset Allocation for Investment Portfolio, Keeps Discount Rate at 6.8%,* CalPERS, Nov, 15, 2021, *available at* https://www.calpers.ca.gov/page/newsroom/calpers-news/2021/calpers-board-new-asset-allocation-keeps-discount-rate-at-six-point-eight-percent.

[35] Harriet Agnew and Josephine Cumbo, *Pension funds seek returns in private assets as public market outlook dims*, Financial Times, Nov. 30, 2021, *available at* https://www.ft.com/content/e4ae2283-0787-4f57-a23c-aa43d55c6745; *see also*, Arleen Jacobius, *CalPERS slates $6.6 billion for alternatives*, Pensions & Investments, Mar. 15, 2022, *available at* https://www.pionline.com/searches-and-hires/calpers-slates-66-billion-alternatives.

[36] See Institutional Limited Partnership Association, *ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners*, at 20, 2019, *available at* https://ilpa.org/wp-content/uploads/2019/06/ILPA-Principles-3.0_2019.pdf (urging limited partners to "reject provisions allowing the GP to reduce all fiduciary duties to the fullest extent allowable by law, as well as any waivers of broad categories of conflicts of interest" and "reject provisions within the LPA that allow the GP or its affiliates to be indemnified for conduct constituting a material breach of the partnership agreement, breach of fiduciary duties or other "for cause" events.").

an audit doesn't mean that those investors don't value audits. Nor does it mean that their underlying beneficiaries (such as retirees) aren't at significantly greater risk because of the lack of an audit. Rather, it simply means that the fund investor determined that the increased risk of lacking an audit was – by itself – not a sufficient basis to lose the investment opportunity.

Again, to maximize the value of audits, these should be provided at the partner level, based on significant testing. While we expect some investment advisers may seek to exclude co-investment vehicles from the requirements, we note that such vehicles may be significant and have very different outcomes for investors than those in related funds.

The federal securities laws and Commission Rules exist, in part, to ensure investors are protected in circumstances – like this – where they may be unable to insist upon essential information and rights.

Lastly, we recognize that parties required to obtain audits often complain of the perceived burdens and costs associated with them. We note that even extremely small organizations associated with governmental agencies, non-profit organizations, and other for-profit entities are regularly obligated to obtain audits of their operations and finances. To the extent that an adviser has funds of limited size and operations, the time and expense of its audit should be commensurate with that scale. Further, we note that there is likely to be another critical benefit of audits: simplification. As policies, procedures, and practices of the adviser and its funds are scrutinized, there will likely be increasing scrutiny of complex, customized, and variable arrangements, which often create additional risks to investors – as well as disparities across investors.

Adviser-Led Secondaries

The Proposal would prohibit an adviser from completing an adviser-led secondary transaction unless the adviser first provides investors with (1) a fairness opinion from an independent third party, and (2) a summary of any material relationships between the adviser and any related person on the one hand, and the opinion provider within the past two years.[37]

One of the great phenomena in the evolution of the private equity markets has been the decade-long rise in secondary buyouts. Historically, the performance of these secondary buyouts has significantly lagged the performance of first-round buyers.[38] More recently, rather than sell fund assets to unaffiliated private parties, advisers are essentially engaging in secondary transactions with their own funds. These adviser-led

[37] Proposal at 16917.
[38] *See, e.g.*, Stefano Bonini, *Secondary Buyouts: Operating Performance and Investment Determinants*, Sept. 2014, *available at* https://air.unimi.it/retrieve/handle/2434/782411/1611370/SBOperformance17_3complete.pdf.

transactions often seek to extend the period of the holding or raise capital, typically by allowing current fund investors to roll their interests into a new vehicle.[39]

The Proposal is intended to cover several different types of secondary transactions, including

> single asset transactions (such as the fund selling a single asset to a new vehicle managed by the adviser), strip sale transactions (such as the fund selling a portion of multiple assets to a new vehicle managed by the adviser), and full fund restructurings (such as the fund selling all of its assets to a new vehicle managed by the adviser).[40]

The risks to investors in both funds and conflicts of interest for advisers in these types of transactions are acute. In particular, advisers often get paid management fees or carried interest upon the closing of transactions.[41] And the greater the valuations of the securities, the greater the potential fees for the adviser.

At the same time, there are also potentially profound impacts on the investors in the different funds. Higher valuations may allow the investors in the legacy fund to realize potentially inflated returns, while providing a significant cost-basis for the investors in the second fund. There may be other incentives for the adviser to engage in a transfer between funds, including different fee arrangements with investors in each.

What happens when the same investors are in both funds? The net impact on those investors may be the ability to claim stated "returns" on the capital – even though the process may have no independent check. For some institutional investors, these valuations – even if not particularly rigorous or testable – may form the basis for claimed returns or funded status. Nevertheless, the greatest likely impacts are simply incurred fees and taxes, as well as a renewed commitment to significant capital outlays for an extended period of time.

For example, in July 2021, Apollo Global Management sold a majority stake in LifePoint Health held by its eighth namesake fund for $2.6 billion.[42] The eighth namesake fund had acquired the interest years earlier for $975 million. The buyer was none other than Apollo's ninth namesake fund.[43] While both funds' boards approved the move, the details of the valuation methodology were never publicly disclosed. Of course, the event

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[39] Proposal, at 16917-18.
[40] Proposal, at 16918.
[41] See, *Id*.
[42] Sabrina Willmer, *Private Equity Powerhouse Books $1.6 Billion Profit Selling Hospital Chain -- to Itself*, Bloomberg, July 29, 2021, *available at* https://www.bloomberg.com/news/articles/2021-07-29/apollo-books-1-6-billion-gain-selling-hospital-chain-to-itself.
[43] *Id.,* (noting that approximately $600 million was provided by other outside investors).

had a dramatic impact on the perceived returns and fees of the investors in the first fund – at least one of which was an investor in the second.

What did all of the investors know about the move? What confidence can investors have that the transaction was anything more than an attempt to "realize" a gain in the first fund and generate additional fees for the adviser? What confidence can investors in the second fund have that they didn't overpay for the asset? What are the other impacts?

Currently, many investment advisers obtain "fairness opinions" as a matter of best practice.[44] Unfortunately, those opinions are not universally provided, nor are they often truly independent.

We urge the Commission to not unduly limit the application of its proposed fairness opinion requirements. While the risks to investors may be somewhat less pronounced if an adviser-led secondary involves a truly open, competitive auction process or liquid assets, the risks are nevertheless still significant. That said, if the Commission wishes to reduce the potential burdens on investment advisers of obtaining and distributing fairness opinions, the Commission could impose the requirement on registered investment advisers only, and apply it to transactions exceeding the lesser of (1) a total notional value of greater than $100 million or (2) 10% of total fund assets.

Prohibited Activities

In recent years, some investment advisers have increasingly exploited their negotiating positions (and information asymmetries) to engage in facially conflicted, abusive practices that simply harm investors. For example, some advisers will charge their private funds (or a subset of fund investors) with fees associated with government investigations into the adviser's business. Similarly, some advisers will also direct portfolio companies to enter long-term relationships with persons related to the adviser (as another revenue stream), and then collect those revenues from portfolio companies or funds even if those services are never performed. These arrangements, for which information is often unavailable or incomplete, may simply serve to enrich persons related to their investment advisers – at the expense of the advisers' funds.

The Proposal would prohibit an investment adviser to a private fund from:

1. Charging certain fees and expenses to a private fund or portfolio investment, including accelerated monitoring fees; fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities; regulatory or compliance expenses or

[44] Proposal, at 16918.

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fees of the adviser or its related persons; or fees and expenses related to a portfolio investment on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment;
2. Reducing the amount of any adviser clawback by the amount of certain taxes;
3. 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; and
4. Borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client.[45]

Interestingly, the Proposal would apply these prohibitions to all advisers, not just those registered with the Commission. Each of the first three practices is facially inconsistent with the investor protection requirements of the Investment Advisers Act of 1940, and should be prohibited. Put simply, we see no policy rationale for permitting an adviser to charge a fund's portfolio investment for unperformed services.[46]

The Proposal would also prohibit investment advisers from shifting fees from some investors to others. As the Proposal notes, "[m]any advisers do not charge co-investment vehicles or other co-investors for fees and expenses relating to unconsummated investments."[47] However, this means that the fees and expenses associated with unconsummated investments are often ultimately borne by main fund investors – essentially ensuring that all of the "downside" of the exploration of an opportunity is borne by one set of investors, but not the potential co-investors. Non-pro rata fee and expense allocations (and other fee shifting between different investors of the private fund adviser) should be prohibited on the grounds that they are inconsistent with the adviser's fiduciary duty.[48]

Somewhat oddly, the "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."[49] The point of prohibiting these activities is to protect US investors. The domicile of the fund is not nearly as relevant as the domicile of the investors who would benefit (or not) from the rules. Further, this limitation would

[45] Proposal, at 16920.
[46] See, *Id.*, at 16922.
[47] *Id.*, at 16926.
[48] See, *Id.*, at 16926.
[49] *Id.*, at 16921.

seem to negate a significant portion of the investors who are the would-be beneficiaries of the provisions. For example, many investment advisers to private funds establish investment vehicles offshore that have US investors for tax and other purposes.[50] Why should a large, US non-profit – which may be investing in an offshore fund – be exposed to these abusive practices? The Commission should not leave a significant swath of private fund investors unprotected by the Proposed reforms.

As described above with respect to the proposed audit requirements, the competitive pressures in the private fund marketplace make it extremely unlikely that mere disclosure will meaningfully check these abusive practices. Investors are very unlikely to be willing or able to negotiate the end of these practices on their own.

Lastly, we urge the Commission to reconsider its approach to one class of prohibited activities: the prohibition on an investment adviser to a private fund "borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client." There are clearly significant opportunities for abuse. At the same time, a fund investor may be well-positioned to provide credit in various forms to a private fund adviser. In this regard, rather than simply prohibiting all extensions of credit by fund investors to a private fund adviser, we recommend that that Commission require (1) a fairness opinion regarding the terms of the extension of credit, and (2) disclosure of the terms of the extension of credit to other investors in the same fund or funds in which the lender participates. This disclosure could give notice to other investors of a potentially improper relationship between the lender and the private fund adviser.

Preferential Treatment

The Proposal would "prohibit all private fund advisers, regardless of whether they are registered with the Commission, from providing preferential terms to certain investors regarding redemption or information about portfolio holdings or exposures."[51] Further, the Proposal would also prohibit private fund investment advisers "from providing *any other preferential treatment* to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons are providing investors in the same fund."[52]

[50] For example, for decades, many US tax-exempt organizations have invested in private funds through offshore "blocker" vehicles so as to avoid unrelated business income tax treatment. *See, e.g.*, PricewaterhouseCoopers International Limited, Unrelated Business Taxable Income (UBTI), Jan. 2017, available at https://www.pwc.com/il/he/events/assets/2017/1-10-us-tax/ubti-alon-sherer.pdf. By applying the Proposal to only funds organized in the US, the Proposal would appear to not capture many US-based investors.
[51] Proposal, at 16928.
[52] *Id.,* (emphasis added).

Side letters are agreements that provide some investors (typically, those that are larger, more sophisticated, or more connected to the adviser) with different – often better – terms than what's contained in private funds' governing documents. While side letters may technically not include the funds' investment advisers as parties, they are typically negotiated between an investment adviser and its larger or more preferred investors.

Side letters typically provide greater rights and transparency for participating investors. Common terms include:

- Revised redemption rights;
- Specialized rights of control regarding fund investments;
- Rights to opt-out of specific fund investments (aka "excuse rights");
- Co-investment rights;
- Rights to periodic or episodic disclosures of holdings;
- Rights to risk assessments of the fund;
- Rights to periodic or episodic communications regarding strategy or investments;
- Demands for assurances, including audits; and
- Revised fee and expense terms.[53]

Side letters often serve to simply attempt to restore participating investors to commercially reasonable terms. This is often necessary because many standard limited partnership agreements and other fund documents typically have very anti-investor terms.

Side letters may be particularly important for investors subject to different regulatory requirements (such as state pension funds, investors subject to the Employee Retirement Income Security Act (''ERISA''), or banks), as they may need transparency into the funds' underlying holdings and risks.[54] And while some investors may benefit as a result of selectively negotiated disclosures agreed upon within side letters, other investors in the same funds (or similar funds) may not. As the Proposal explains:

> Selective disclosure of portfolio holdings or exposures can result in profits or avoidance of losses among those who were privy to the information beforehand at the expense of investors who did not benefit from such transparency. In addition, such information could enable an investor to trade in portfolio holdings in a way that ''front-runs'' or otherwise disadvantages the fund or other clients of the adviser. Granting preferential transparency, for example through side letters, presents a sales practice that is contrary to the public

[53] The content of side letters may vary widely from investor to investor, fund to fund, adviser to adviser, and asset class to asset class. At times, we have seen some side letters that appear to give rise to questions regarding whether the beneficiary may actually be considered a general partner, rather than a limited partner.
[54] Proposal, at 16928.

> interest and protection of investors because it preferences one investor at the expense of another. An adviser may agree to provide preferential information rights to a certain investor in exchange for something of benefit to the adviser.[55]

Private fund investors often lack essential information about preferential terms granted to other investors, including terms that may directly impact the funds' investments, performance, and fees.

The Proposal would generally prohibit preferential terms unless the adviser provides information about them in a written notice to all investors.[56] The details of specific preferential terms may be extremely relevant to investors. As a result, the Proposal would demand a relatively significant degree of specificity for those disclosures. As the Proposal explains,

> if an adviser provides an investor with lower fee terms in exchange for a significantly higher capital contribution than paid by others, we do not believe that mere disclosure that some investors pay a lower fee is specific enough. Instead, we believe an adviser must describe the lower fee terms, including the applicable rate (or range of rates if multiple investors pay such lower fees), in order to provide specific information as required by the proposed rule. An adviser could comply with the proposed disclosure requirements by providing copies of side letters (with identifying information regarding the other investors redacted). Alternatively, an adviser could provide a written summary of the preferential terms provided to other investors in the same private fund, provided the summary specifically describes the preferential treatment.[57]

Fueled, in part by these side letters, there is often significant variability in the fees paid by different investors.[58] This variability is often a function of the size of the investor, its past performance, experience, negotiating acumen, and other factors.[59]

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[55] Proposal, at 16929.
[56] *Id.*, at 16930.
[57] *Id.*
[58] Juliane Begenau and Emil Siriwardane, *How Do Private Equity Fees Vary Across Public Pensions?*, Harvard Business School Working Paper, No. 20-073, Jan. 2020 (Rev. March 2022), *available at* https://www.hbs.edu/ris/Publication%20Files/20-073rev3-15-22_e618b34f-d9c8-4c4b-9958-300e3efb56a1.pdf.
[59] *Id.*

We recognize that some investment advisers may seek to resist providing disclosures or other preferential terms to some preferred investors via side letters, if those terms were disclosed to all investors. However, potential threats by investment advisers that they would eliminate these arrangements are simply not credible.

Private fund advisers want large, sophisticated, and experienced investors to participate in their funds. Further, as we have personally experienced, even amongst the largest, most sophisticated investors in the world, the lack of information regarding side letters creates significant risks. Put simply, even the investors who may most often benefit from side letters are often disadvantaged by them. Prohibiting some preferential terms will thus both raise the overall level of investor protections in private funds, but also reduce costs and inefficiencies of lengthy negotiations and severe information and rights asymmetries across investors.

By simply providing basic transparency into preferential treatment, all investors could better protect themselves from risks to their investments (including potentially higher fees or worse performance) that may be created by preferences granted to other investors. If information regarding preferential terms were shared with all investors in the funds (and similar funds), then other investors could better identify where their interests may diverge from the advisers' or their fellow investors, including on co-investment rights, redemption rights, and other areas. They could also better identify whether the adviser is adhering to the terms of their obligations, such as most-favored-nation clauses.

Conclusion

The current marketplace for private fund investing is extremely skewed towards private fund advisers, and the Commission must intervene to provide transparency and competitive balance for investors. Even some of the largest, most sophisticated asset owners are currently concerned that raising concerns with their own contractual terms may lead to them being disfavored or discriminated against by private fund advisers. In fact, we have even heard some asset owners express fear that they may be discriminated against for simply publicly commenting on this Proposal. That is not a healthy market.

Thank you for the opportunity to offer comments on the Proposal, which we urge the Commission to revise and adopt without delay. Please feel free to contact me by email at ty@healthymarkets.org or telephone at (202) 909-6138 for any follow up.

Sincerely,

Tyler Gellasch
Executive Director