U.S. Chamber of Commerce

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Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
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Re: Proposed Rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews [Release No. IA-5955; File No. S7-03-22]; 87 FR 16886

Dear Ms. Countryman:

The U.S. Chamber of Commerce's ("the Chamber") Center for Capital Markets Competitiveness ("CCMC") appreciates the opportunity to comment on the Securities and Exchange Commission's Proposed Rule on "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews" ("the Proposal") that would amend private fund reporting rules and prohibit certain types of conduct. The Commission asserts that the purpose of the proposed rules "is to protect those who directly or indirectly invest in private funds by increasing visibility into certain practices, establishing requirements to address certain practices that have the potential to lead to investor harm, and prohibiting adviser activity that the Commission believes is contrary to the public interest and the protection of investors."[1]

The Proposal seeks to require registered investment advisers to provide transparency to private fund investors regarding the full cost of investing in private funds and standardized performance information regarding such private funds. The Proposal would also require registered private fund advisers to obtain a financial statement audit of each private fund they advise annually and on liquidation from an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (the "PCAOB"), and, in connection with an adviser-led secondary transaction, a fairness opinion from an independent opinion provider.

Further, the Proposal would prohibit all private fund advisers, even those that are not registered with the Commission, from engaging in certain sales practices, taking certain actions perceived as susceptible to conflicts of interest, and agreeing to certain compensation schemes with private fund investors. Finally, the Proposal seeks to prohibit outright certain types of

[1] Securities and Exchange Commission, Release No. IA-5955; File No. S7-03-22 (February 9, 2022), 87 FR 16,888, at 16,890, available at https://www.sec.gov/rules/proposed/2022/ia-5955.pdf.

preferential treatment to private fund investors, and to prohibit other types of preferential treatment unless the adviser discloses such treatment to other current and prospective investors. The Proposal would also make corresponding amendments to the books and records rule under the Advisers Act to facilitate compliance with these proposed new rules and assist the Commission's examination staff.

While we appreciate that the Proposal seeks to enhance protections for investors in private funds, the Chamber has significant concerns with various aspects of the Proposal. As explained in further detail throughout this letter, the Chamber is primarily concerned that the Proposal would upend the private funds marketplace, replacing the highly successful, disclosure-based regulatory regime that has evolved over many years with a prescriptive regime that needlessly imposes on highly-sophisticated investors policy prescriptions that are more suitable to retail investors, and substantially limiting investors' and advisers' flexibility to negotiate mutually agreeable terms. These changes would impose substantial costs on investors and advisers alike, including by forcing investors and advisers to renegotiate key terms of existing funds without the benefit of grandfathering provisions, all with dramatic negative effects on private fund investors and other stakeholders in the private funds marketplace (including the Commission itself, which will be forced to reallocate scarce resources to policing prescriptive rules for sophisticated private fund investors, and away from the protection of "Main Street" investors).

Further, the Chamber is concerned that the Commission has asserted its authority to promulgate many of the rules in the Proposal without a sufficient legal basis to do so.

<u>The Proposal would fundamentally change regulation of one of the most sophisticated, efficient and well-developed markets for capital formation and investment in the world.</u>

The private funds marketplace is critical to capital formation globally and in the United States. It has evolved over time into a highly efficient and well-developed market characterized by a high degree of transparency and sophistication among market participants. The Proposal would fundamentally change the market in material ways that would adversely impact the operation and efficiency of the market. More important even than the changes themselves is the fundamental transformation the Proposal represents in the Commission's approach to regulating investment advisers and the private funds marketplace. Historically, the Commission has taken the view that advisory clients and private fund investors, (the latter a highly sophisticated group all or nearly all of which are also accredited investors or qualified purchasers), should be free to act in their own best interest in negotiating the terms of advisory services and investments in private funds. Thus, although fund advisers cannot contract out of their fiduciary duties under the Advisers Act, the parties to an advisory contract should be free to shape the terms of their

relationship as they see fit, so long as the adviser fully and fairly discloses potential conflicts and the client or investor gave informed consent.[2]

The Proposal, by contrast, aims to protect private fund investors by directly prohibiting in all cases many practices that the Commission believes *could* be deemed unfair *if* the practices were not fully and fairly disclosed. This echoes the approach adopted by Congress in the Investment Company Act of 1940, and, if applied to private fund investors, represents "another step toward erasing any distinction afforded by the exemption from registration" for private funds.[3] If forced to comply with these rules, the private fund markets would suffer massive disruptions as investors and advisers alike digest and implement the new rules.

The Proposal is a solution in search of a problem.

Throughout the Proposal, the Commission refers generically to potential harms that private fund investors may suffer in certain circumstances. However, the Commission does not identify with specificity any market failures under the existing disclosure-based regime that both justify intervention of this magnitude and cannot be addressed using currently available remedies. More generally, the Commission has not sufficiently shown any need to expand, nor has the Commission presented any compelling data to support expanding, its rulemaking authority to contemplate the Proposal's intrusion into the contractual agreements between private fund advisers and investors, and the concomitant disruption that intrusion would cause.

As one example, the Commission believes that granting preferential liquidity to some, but not all, investors in a private fund could, to the extent doing so risked losses to other investors, violate the adviser's duty of loyalty to its investors. Preferential liquidity terms are common in the private fund industry, serve legitimate business purposes for both fund sponsors and investors, and are subject to negotiation between sophisticated parties. The Commission has not provided a sufficient rationale and basis to adopt the proposed prohibitions in this area, which will have significant adverse impacts across the industry. As the Proposal provides neither grandfathering for existing funds nor a sufficient transition period, if the Proposal were adopted, advisers would need to re-examine each existing agreement to determine if it provides

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[2] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248, 84 Fed. Reg. 33,669, at 33,671 (July 12, 2019), available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf (the "Fiduciary Interpretation"). The federal courts have similarly recognized the existence of a fiduciary duty under the Advisers Act, most notably in the Supreme Court's 1963 decision in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), and the concomitant obligation on advisers to fully disclose potential conflicts. *See also* Commissioner Hester M. Peirce, "Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking," February 9, 2022, available at https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922 (the "Peirce Dissent"), n. 5 (citing to Remarks of SEC Commissioner Troy A. Paredes, "Statement at SEC Open Meeting: Rules Implementing Amendments to the Investment Advisers Act of 1940 and Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers" (June 22, 2011), available at https://www.sec.gov/news/speech/2011/spch062211tap-items-1-2.htm.).

[3] Peirce Dissent.

preferential liquidity terms to any investor and to ensure that those terms were not then prohibited. The costs of implementing this provision alone would be substantial. Moreover, there already exist remedies under current law that are appropriate to address this concern. For example, the Commission could respond (and has in the past responded) by bringing an enforcement action under Section 206(4).[4] Nevertheless, the Commission summarily concludes that this rulemaking, together with its concomitant recordkeeping and disclosure obligations, is necessary to protect highly sophisticated private fund investors from this risk.

Another example is the proposed prohibition on charging a portfolio investment for monitoring and similar fees that the investment adviser does not, or does not reasonably expect to, provide. The proposal targets the practice of accelerating monitoring fees in certain circumstances but will also inhibit the ability of private fund sponsors to employ other fee arrangements. The Proposal (correctly, in our view), identifies that an adviser faces many potential conflicts of interest in this scenario, including that it may have an incentive to cause the fund to exit a portfolio investment earlier than anticipated, or to seek portfolio investments for its own benefit rather than for the fund's. However, the Proposal conspicuously omits any discussion of the multiple settled enforcement actions brought against private fund sponsors in recent years related to this very activity. In those actions, the Commission successfully asserted that fund sponsors provided inadequate disclosure regarding accelerated fee practices, such that investors could not effectively provide informed consent to the practice. Three such enforcement actions alone, in 2015, 2016 and 2017, netted aggregate settlements for the Commission of over $100 million.[5] This focus on fair and effective disclosure affording the opportunity for informed consent has been the hallmark of Advisers Act jurisprudence for decades, and focuses the attention of investment advisers on the fiduciary duty owed to their clients and to private fund investors. Yet, the Proposal seeks to replace this approach with prescriptive rules addressing specific issues even in the face of recent proof that the Commission has effectively addressed those very issues by focusing on an adviser's fiduciary obligations, and bringing enforcement action when those obligations are not met.

The Proposal would have serious negative implications for funds, their advisers, and investors.

In many respects, the Proposal would hinder sophisticated investors instead of helping them. Sophisticated parties prefer to negotiate, and are accustomed to negotiating, the terms of

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[4] *See*, *e.g.*, In the Matter of Aria Partners GP, LLC, Advisers Act Release No. IA-4991 (August 22, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4991.pdf (permitting certain investors to redeem interests in a private fund on 60 days' notice, while requiring other investors to give 90 days' notice, which resulted in materially different full redemption amounts for certain investors, contributed to violations of Section 206(4) of the Advisers Act and Rules 206(4)-2, -6 and -7).

[5] In the Matter of Blackstone Management Partners L.L.C., Advisers Act Release No. IA-4219 (October 7, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4219.pdf (settlement of $38.9 million); In the Matter of Apollo Management V, L.P., Advisers Act Release No. IA-4493 (August 23, 2016), available at https://www.sec.gov/litigation/admin/2016/ia-4493.pdf (settlement of $52.7 million); In the Matter of TPG Capital Advisors, LLC, Advisers Act Release No. IA-4830 (December 21, 2017), available at https://www.sec.gov/litigation/admin/2017/ia-4830.pdf (settlement of $12.8 million).

their investments. However, the Proposal would prevent parties from negotiating critical terms, even given adequate disclosure, and freely agreeing to a mutually beneficial outcome. Consequently, the proposed new provisions would prevent current investment activity that promotes capital formation from happening in the future, to the detriment of U.S. investors and U.S. businesses seeking investment capital. Moreover, the costs of compliance associated with the Proposal, whether borne by the advisers or passed on to investors in the form of increased fees (and/or more limited investment opportunities), will increase investment expenses for investors. In some instances, it may not even be possible to bring existing deals into compliance with the Proposal. The effects of increased investor expenses and restructuring of existing deals that were negotiated consistent with existing law and regulation do not appear to be, but should be, incorporated into the cost-benefit analysis performed in connection with the Proposal.

Moreover, institutional investors, whose capital makes up a substantial majority of all capital invested in private funds, are among the most sophisticated market participants. Our members uniformly report that there is no asymmetry of power or information between these investors and advisers. However, to focus its attention on safeguarding this small subset of investors, who have substantial resources and are represented by sophisticated, experienced investment professionals and other advisers and experts, the Commission must necessarily divert scarce resources away from the protection of retail investors. As Commissioner Peirce noted in her dissent to the Proposal, the Commission historically has treated protection of retail investors as a top priority, even after the Dodd-Frank Act created a new oversight regime for private fund advisers. With the change in approach embodied in the Proposal, the Commission would need to redeploy resources away from retail investors. This does not appear to serve any compelling policy or regulatory purpose given the sophistication of participants in the private funds market and the statutory framework established by Congress that exempts private funds from most regulation.

As a further example, the Proposal would significantly affect the market for collateralized loan obligations (CLOs), a subset of the private funds marketplace over $1 trillion in size and consisting almost exclusively of institutional investors that are both qualified purchasers and qualified institutional buyers (QIBs). The Proposal does not mention CLOs; however, since CLOs generally rely on the exemption from registration under Section 3(c)(7) of the 1940 Act, they are "private funds" and therefore covered by the Proposal. CLOs are heavily negotiated between investors and sponsors, and CLO transactions uniformly incorporate stringent investor protections, including complex, fixed waterfall provisions for payment of fees and expenses, and the use of independent trustees to make distributions and to monitor and report to investors on the CLO's performance. Nevertheless, the Proposal would require the Commission to deploy resources for the benefit of these ultra-sophisticated investors, and away from retail investors. The Proposal's failure to provide grandfathering for existing investments would be particularly onerous for CLOs given that they are debt instruments that have noteholders. For example, amending all CLO indentures would be almost impossible because it would involve having to re-negotiate with all of the noteholders in each of the tranches of a CLO. In light of the level of

sophistication of CLO investors, and the investor protections already present in nearly all CLO transactions, the Commission should expressly exclude CLO transactions from the scope of the Proposal. CLOs provide a key source of debt-financing for non-investment grade companies to expand their operations and make improvements that create jobs and economic growth. Since they are a critical source of capital for companies, burdening CLOs with additional and unnecessary regulatory burdens will constrict the supply and increase the cost of such capital for companies.

The Commission's rulemaking proceeding raises serious questions under the Administrative Procedure Act.

Core components of the Proposal are based on rulemaking authority that purports to derive from, among others, Sections 206(4), 211(a) and 211(h) of the Investment Advisers Act of 1940, as amended (the "Advisers Act").[6] Section 206(4) provides in relevant part that "[i]t shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly— To engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." The practices that the Commission seeks to prohibit generally are commonplace in the private funds industry, and as noted above, the Commission has often used its current enforcement authority to effectively address abuses. The Proposal does not set forth a reasonable basis to now declare that these commonplace practices and activities are in all cases "fraudulent, deceptive or manipulative" and must be prohibited entirely under Section 206(4), even when sophisticated investors understand and agree to their use. Accordingly, the Proposal may exceed the rulemaking authority granted under this provision.

Additionally, Section 211(h) provides in relevant part that the Commission "shall- (1) Facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and (2) Examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors." This provision was added to the Advisers Act in connection with the enactment of Dodd-Frank Act provisions expressly intended to enhance the Commission's

[6] The Commission also cites Section 203(d) as a basis for its statutory authority, which provides in relevant part that: "Any provision of this title … which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith, shall also prohibit any such act, practice, or course of business by any investment adviser registered pursuant to this section or any person acting on behalf of such an investment adviser, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith." This provision makes conduct unlawful whether or not means of interstate commerce are utilized, but does not grant rulemaking authority to the Commission, much less on the matters covered by the Proposal.

regulatory authority to establish fiduciary standards in the retail market for individual investors.[7] It was never intended to permit the Commission to promulgate rules meant to supplant fiduciary standards with prescriptive prohibitions addressing perceived problems in the private funds market, in which participants are among the most sophisticated in the world.

Finally, Section 706(2)(A) of the Administrative Procedure Act instructs courts reviewing regulation to invalidate any agency action found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." In exercising its rulemaking authority, the Commission has the statutory obligation to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 78c(f); id. §§ 78w(a)(2), 80a–2(c). The Commission also must "apprise itself — and hence the public and the Congress — of the economic consequences of a proposed regulation before it decides whether to adopt the measure." *Chamber of Com. of U.S. v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005).

The Proposal, if adopted, may violate the Administrative Procedure Act by imposing sharp new restrictions on the activities of private funds and their advisers, without a coherent (much less reasonable) justification for those new restrictions; without an adequate explanation of whether and how the new restrictions will promote efficiency, competition, and capital formation; and without an adequate assessment of the economic consequences. Moreover, the Proposal would depart from Congress' and the Commission's long-standing approach relating to the regulation of private funds, which provides broad exemptions for private funds and relies heavily on extensive disclosures with which funds must comply. The Commission has failed to provide a reasonable basis to significantly change regulation in this area.

Specific Concerns Raised by the Proposal

Fund expenses

The Proposal precludes an adviser from charging a private fund for fees or expenses associated with an examination or investigation of the adviser or any of its related persons as well as regulatory and compliance fees and expenses of the adviser or its related persons, even where it is disclosed that these regulatory and compliance fees and expenses will be charged to the private fund. The Commission draws a distinction between fees and expenses directly related to the compliance activities of a private fund, which may be passed through to the private fund, and fees and expenses incurred by an adviser in connection with examinations or investigations of the private fund adviser or the regulatory or compliance fees of the adviser or its related persons, such as those associated with preparing and filing the adviser's Form ADV.

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[7] *See*, *e.g.*, H.R. REP. NO. 111-517, at 727 (Conf. Rep.) (2010) (Subtitle A of Title X of the Dodd-Frank Act expressly directs the Commission "to study the standards of care applicable to broker-dealers and investment advisers giving investment advice to retail customers, and … authorizes the Commission to promulgate rules imposing a fiduciary duty on broker-dealers and investment advisers to protect retail customers.") This authority is provided to the Commission with respect to investment advisers pursuant to new Section 211(g). *Id.* at 468.

As an initial matter, the Commission recognizes that some advisers use a pass-through expense structure where all or a substantial portion of the adviser's expenses are paid by the private fund, but the adviser does not charge the private fund a management, advisory, or similar fee. The Commission concedes that these advisers would be forced to re-structure their fee and expense model. Given that the Proposal does not permit grandfathering, this change will result in substantial renegotiation of the terms of many existing funds in a context where the adviser has little negotiating leverage and is very likely to result in the early termination of several funds.

More generally, the practical effects of the Proposal may not be what the Commission intends. The Proposal focuses on preventing advisers from passing on to investors expenses that, from the Commission's perspective, should be for the adviser's account. However, the Proposal does not prevent advisers from charging a management fee, nor does it mandate the amount of any such management fee. In lieu of quantifying their regulatory and compliance expenses to investors, advisers may simply charge a higher management fee, and pay their regulatory and compliance expenses out of the management fee without disclosing those regulatory and compliance expenses to investors. As a result, investors would ultimately pay the adviser's regulatory and costs indirectly, with less transparency into advisers' actual costs of complying with the Commission's regulatory regime than they now have.

Moreover, advisers may in some instances be unable to increase their management fees to offset regulatory and compliance costs that previously were borne in part or in whole by private funds. This is likely to result in reduced investment in compliance functions, especially by smaller and emerging advisers, who often rely on management fees as their sole source of operating revenues and may not have other sources of capital with which to offset their increased regulatory and compliance costs. Discouraging advisers from investing in their compliance infrastructures would reduce investor protections (requiring the Commission to allocate further resources to protecting highly-sophisticated private fund investors) and undermine regulatory and other initiatives intended to foster compliance.

Restrictions on indemnification provisions and regulation of contracts

The Proposal prohibits an adviser to a private fund, regardless of registration status, from directly or indirectly seeking reimbursement, indemnification, or exculpation by, or limitation of its liability to, the private fund for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund. The Commission argues that exculpating advisers for breach of fiduciary duty or indemnifying or reimbursing advisers for damages that result from a breach, reduces the adviser's incentive to comply with the required standard of conduct. This result is neither in the public interest nor consistent with investor protection. The Commission takes the position that such clauses (sometimes referred to as "hedge clauses") are especially problematic insofar as they may lead investors to believe that the adviser is contractually not obligated to comply with the Advisers Act, or result in investors with relatively less bargaining power bearing the brunt of such arrangements (because, according to

the Commission, investors with greater bargaining power can obtain individualized protections in the form of side letter provisions).

Putting aside the Proposal's massive change to the Commission's approach to regulating private funds, and the costs associated with implementing the Proposal, changing the liability standard for advisers to private funds may not lead to the Commission's desired result. The Proposal starts from the premise that even highly-sophisticated private fund investors cannot protect themselves from an adviser's bad conduct in the performance of an advisory contract. Therefore, the Commission should prescribe ex ante what "bad conduct" means in all contexts, rather than permitting investors to negotiate a mutually acceptable solution with an adviser that takes into account the investor's relationship with the adviser and the specific transaction as to which the adviser will advise. As noted above, this is inconsistent both with the fundamental premise that sophisticated parties should be able to freely determine the provisions of contracts without arbitrary or unreasonable legal restrictions, and with the Commission's prior position, reiterated in the Fiduciary Interpretation, that sophisticated parties to an advisory contract should be free to shape their relationship as they see fit, so long as the adviser fully and fairly discloses potential conflicts and the client gives informed consent. Under the Proposal, these inconsistencies will raise costs for advisers and investors and are likely to create more limited investment opportunities, which will harm capital formation.

In addition, the Commission suggests in the Proposal that making an adviser liable for breaches of its duty of care, even when the errors are unintentional, will help to maintain the adviser's incentive to comply. In reality, it will increase costs for investors without the corresponding benefits sought by the Commission. The imposition of a negligence standard, which is more onerous than what is permitted for retail products such as registered investment companies (where advisers are held to a gross negligence standard), would further reverse the longstanding distinction between retail funds and private funds. In addition, imposition of the negligence standard for private funds will increase the costs of obtaining directors' and officers' and errors and omissions insurance, which routinely covers the actual or alleged negligence of fiduciaries, and the increased cost will be borne by the private fund and, ultimately, its investors. This will make investments in private funds more expensive for private fund investors than is currently the case with little or no corresponding benefit to investors.

Compensation models

The Commission asks whether it should ban outright the use of deal-by-deal or American-style waterfalls in private funds. Similarly, the Commission asks whether it should prohibit the use of the familiar "2 and 20" compensation model for private fund advisers. The proposition that the Commission should ban the use of specific compensation arrangements in a private fund for any reason, let alone compensation arrangements that are so commonly used as to be foundational for private funds across the industry, is deeply inconsistent with the idea that sophisticated parties should be able to freely determine the provisions of contracts without arbitrary or unreasonable legal restrictions. Moreover, any action by the Commission to ban the

use of deal-by-deal waterfalls, or the "2 and 20" compensation model, would present extraordinary, and extraordinarily damaging, disruptions to the private funds market given their widespread use, severely hindering both the market's existing function and its prospects for long-term growth.

Preferential terms

The Proposal would prohibit all private fund advisers from (i) providing preferential terms to certain investors in private funds or in substantially similar pools of assets (such as parallel funds) regarding redemption, or (ii) providing certain information about portfolio holdings or exposures only to certain private fund investors where the adviser reasonably expects that providing such information would have a material, negative effect on other investors in the private fund. The Chamber believes that the Commission's underlying assumption that these types of terms are inappropriate in all cases is [seriously] flawed. Preferential terms can serve legitimate business purposes for both fund sponsors and investors, and sophisticated investors who invest in private funds are perfectly capable of protecting themselves given adequate disclosure. Moreover, the costs associated with these changes — both direct costs of compliance borne by advisers and investors, and deadweight losses resulting from increased inefficiency and reduced transaction volume — will greatly exceed any perceived benefits realized by certain private fund investors who will receive potential protection for which they would otherwise not have been able (or willing) to negotiate.

The prohibition on preferential liquidity would matter principally to those private funds that have agreed arrangements with investors outside the four corners of a private fund's governing documents (i.e., side letters). Typical private equity-style funds do not offer liquidity to investors except on termination of the fund. (The only common exception to this rule for private equity funds is withdrawal to prevent the fund or the investor from suffering legal, regulatory or tax problems — an exception meant to protect the fund and its investors, but which may not be permitted under the Proposal.) Nonetheless, the Commission attempts to justify the blanket prohibition by stating that "[i]nvestors who do receive preferential terms may also receive information over the course of a fund's life that the investors can use to their own gain but to the detriment of the fund, and by extension, the other investors. For instance, if a fund was heavily invested in a particular sector and an investor with early redemption rights learned that sector was expected to suffer deterioration, that investor could submit a redemption request, securing the funds early but forcing the fund to sell assets in a declining market, harming the other investors." The concerns cited by the Commission do not reflect market realities (and indeed reflect a significant misunderstanding regarding how many private funds operate) and would decrease, rather than enhance, overall liquidity for investors in this market. For example, in typical private equity funds, preferential liquidity is not provided on the basis described by the Commission — the fact that a particular sector in which the fund has invested may deteriorate, without more, typically would not permit withdrawal as the Commission contemplates. Relatedly, the Commission should clarify that liquidity terms set out in a private fund's governing

documents (for example, multiple share classes that offer different redemption terms) would be not considered "preferential" rights for purposes of the Proposal.

The Proposal would allow other types of preferential treatment, but would require that such treatment must be disclosed in advance written notice to prospective investors and annual written notice to current investors. An adviser would need to describe specifically the preferential treatment to convey its relevance. The proposed approach is impractical and onerous. Because the Proposal does not describe with specificity what is, or is not, "preferential treatment," advisers would be left with difficult determinations of what must be disclosed, and in how much detail. Moreover, those determinations would be subject to second-guessing by both the Commission and by investors, increasing an adviser's cost and risk profiles. While the Commission suggests that an adviser could comply with the proposed disclosure requirements by simply providing copies of side letters (with identifying information regarding the other investors redacted), this is not a workable approach. Apart from difficult investor relationship and management issues that may result – for example, some investors require strict confidentiality with respect to their side letters for reasons unrelated to the private fund, and may be unwilling to invest in a fund where their side letter would be disclosed, even with redactions –advisers using this strategy would have substantial difficulty using "most favored nations" clauses, a common term in private fund investments that reduces the cost and effort associated with investor management. This is because the Proposal implies that, if another investor negotiates a side letter with more favorable terms, every investor should be entitled to the same terms, even if they have not negotiated for them.

The timing of the Proposal's delivery requirements also would require departures from existing practices and would substantially increase costs for advisers and fund investors. Required timing for notice of preferential terms would differ depending on whether the recipient is a prospective or existing investor in the private fund. For a prospective investor, the notice would need to be provided, in writing, prior to the investor's investment. This would add time, expense and risk for advisers to the closing process; closings would necessarily be slowed while the adviser provides notice of every preferential term to potential investors, leaving advisers vulnerable to failed closings, but failure to provide such notice could have severe and unexpected consequences for the adviser and for the private fund. Moreover, this presents advisers a substantial impediment to closing (especially a first closing): every investor will have an incentive to wait until the last possible moment to close, to see whether other investors have successfully negotiated, or will successfully negotiate, for better terms.

For an existing investor, the adviser would have to "distribute" the notice annually if any preferential treatment is provided to an investor since the last notice. This would require substantial new monitoring and personnel costs, and also would create a difficult new set of determinations for advisers about what interactions with investors during the life of a private fund constitute preferential treatment. It is common practice, for example, for an adviser to discuss difficult questions that may arise informally with certain investors (as a way to take

advantage of the sophistication and experience private fund investors bring to the table), or for an adviser's investor relations staff to informally discuss information with certain investors in a manner that is not documented in a side letter. If those activities were to constitute preferential treatment, the adviser could be subject to severe sanction under the Proposal. This would necessarily chill an adviser's interactions with all of its private fund investors, which would in turn negatively affect all of the investors. This would be self-defeating for the Commission to the extent that the Proposal is designed to spur information flow.

Accounting issues

The Proposal would require private funds to have annual financial statement audits performed by independent public accounting firms registered with and subject to regular inspections by the PCAOB. The Commission believes, in addition to providing protection for the fund and its investors against misappropriation of fund assets, that an 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.

The Chamber recognizes the value of financial statement audits performed by independent public accounting firms and the vital role audits play in our markets – both public and private. Nonetheless, there are several matters of concern with the Proposal, including ones related to investor protection and competition.

For example, the proposed audit requirements may give private fund investors a false sense of protection. The PCAOB does not have the authority to inspect audit engagements that involve private fund financial statements. The Sarbanes-Oxley Act of 2002 ("SOX") gives the PCAOB authority over audits (and auditors) of issuers, and the Dodd-Frank Act extends the PCAOB's authority to certain broker-dealer auditors. The Proposal is premised on the notion that, although the PCAOB cannot inspect private fund audit engagements, the quality control systems of such audit firms would be subject to PCAOB inspections through the registered audit firm's issuer and/or broker-dealer audits. The Chamber questions whether private fund investors will understand this limitation. It seems likely that even highly sophisticated private fund investors will assume the audit engagement itself is subject to PCAOB inspection because the audit firm is required to be registered with and regularly inspected by the PCAOB.

Further, the assumption in the Proposal of timely PCAOB inspection of audit firm quality control systems appears flawed because the PCAOB has not yet established a regular inspection program for broker-dealer audits. Rather, the PCAOB continues to inspect under an interim program that took effect in 2011. However, it is not clear whether the PCAOB has inspected all registered accounting firms that only audit broker-dealers (and not issuers) even once during the last decade. Moreover, investors cannot make this determination, because the PCAOB does not disclose the names of audit firms inspected under the interim broker-dealer inspection program. The PCAOB provides an annual overall (summary) report, but no individual accounting firm inspection reports are available under the interim program and the names of the inspected firms

are not otherwise publicly disclosed. Thus, unless an accounting firm also audits issuers, there is no publicly available PCAOB inspection report for an individual firm.

An additional point of confusion for investors regarding PCAOB authority and oversight may occur because most private fund financial statement audits are expected to be conducted in accordance with Generally Accepted Auditing Standards ("GAAS"), as promulgated by the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA") – not PCAOB auditing standards. As discussed in the Proposal, a private fund financial statement audit would not be within the jurisdiction of the PCAOB. Therefore, when conducting such an audit in accordance with the standards of the PCAOB, the auditor would also be required to conduct the audit in accordance with GAAS. As a result, although required to use a PCAOB-registered and regularly inspected audit firm, private funds are unlikely to contract and pay for an audit approach using both GAAS and PCAOB auditing standards.

Additionally, the Proposal would limit the pool of auditors that are eligible to perform the required services for private funds to audit firms currently registered and inspected by the PCAOB. The Chamber has several concerns related to the competitive effects of the proposed requirement. For example, by limiting the supply of available audit firms, the proposed requirements will likely increase the costs of audits not only for private funds, but for other broker-dealer audits as well. Further, given the potentially limited supply of such firms, the Chamber is concerned that some (perhaps many) private funds will not be able to engage a PCAOB registered and inspected firm to conduct the necessary financial statement audits. The Commission estimates about 11% of relevant private funds do not now undergo financial statement audits, which encompasses almost 5,000 private funds. An unknown number of the remaining 89% of private funds (over 39,000) do not currently use PCAOB registered and inspected accounting firms and would have to engage one. These numbers represent a very large increase in demand for PCAOB inspected audit firms, considering the PCAOB website currently discloses that 359 PCAOB registered audit firms perform audits of about 3,500 broker-dealers.

The Chamber therefore urges the Commission to analyze whether an adequate supply of audit firms would be available to provide the necessary services before adopting the proposed requirements. On one hand, it is not clear how many firms currently auditing issuers and/or broker-dealers will add private fund audits in response to an increased demand. On the other hand, because of regulatory, legal, and other concerns, accounting firms not currently registered and inspected by the PCAOB may be disinclined to take on new issuer and/or broker-dealer audits to audit private fund financial statements, too. Yet, unless the current supply of PCAOB-eligible audit firms significantly expands, a very large number of private funds will be competing for the very limited supply of (359) PCAOB registered audit firms – and many private funds will likely come up short. Moreover, it is unclear whether the PCAOB has the "bandwidth" to absorb a significant expansion in the number of registered and inspected audit firms (even though the PCAOB will not be inspecting individual private fund audits).

Finally, the Chamber encourages the Commission to examine other potential competitive effects of the Proposal – especially for audit services in the smaller audit firm segment of the market. For example, a consolidation of the market may already be occurring. Over the last decade, the number of PCAOB-registered firms performing broker-dealer audits declined from about 800 to 359. The PCAOB also reports that about 4,400 broker-dealers filed audited annual financial statements with the Commission in 2011 and this number declined to about 3,500 broker-dealers by 2020 (the latest available information). The Commission needs to better understand the causal factors for these downward trends to fully consider the consequences of the Proposal for the private fund/broker-dealer audit markets.

Grandfathering

By its terms, the Proposal would apply to both new and existing private funds, notwithstanding that existing private fund agreements represent heavily negotiated agreements that sophisticated parties freely enter. The consequences of a lack of grandfathering would be enormously disruptive to the industry and would materially and negatively impact funds, investors and advisers alike. The scope and size of the task alone would be daunting. At the end of the third quarter of 2021, based solely on Form PF filings (and therefore only on the largest advisers), there were some 37,338 private funds.[8] The number of investors in those funds is a significant multiple of that number. If the Proposal were adopted, then, for each and every one of those funds, regardless of whether the fund has just launched, is actively investing, or is in wind-down, the adviser would need to determine whether and to what extent the fund's terms (including side letters) must be amended to bring the fund into compliance, and then reopen and complete negotiations with each of the fund's investors. Advisers with multiple funds would be obligated to bring all of their funds into compliance simultaneously.

The costs associated with these negotiations are likely to substantially exceed even the high costs acknowledged by the Commission. It will be expensive, difficult and time-consuming for advisers to bring existing agreements into compliance with the Proposal; it may even be impossible in some instances, since advisers will have no bargaining power and fund investors will have no incentives to cooperate. Smaller and emerging advisers in particular may be completely overwhelmed by the burdens of simultaneously managing, and fundamentally altering, their funds. As the Proposal lacks a grandfathering provision for existing funds, this may result in a significant number of fund closures, since if the parties to a fund cannot agree on amendments, the adviser may be forced to liquidate the fund. If the Proposal is adopted, the Chamber urges the Commission to provide for grandfathering with respect to existing funds. The operational and other disruptions that would otherwise occur would have significant adverse consequences for all involved.

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[8] Securities and Exchange Commission, Division of Investment Management, Analytics Office, Private Funds Statistics, Third Calendar Quarter 2021 (March 30, 2022), available at https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2021-q3.pdf.

Transition/Implementation

If the Proposal is adopted, the compliance date must be significantly longer than the twelve-month transition period outlined in the Proposal given the nature of the changes and the significant market disruptions that will result. Advisers and private fund investors alike would be required to take extraordinary actions to comply with the rules if adopted. They would need simultaneously to evaluate the ramifications of the rules for their businesses, evaluate whether and how to bring existing private funds (of which there may be dozens or more) into compliance with the rules, amend many if not all fund documents to eliminate prohibited terms, re-negotiate terms with dozens if not hundreds of investors in their funds, build and implement compliance structures and systems to address new elements of the rules such as annual reporting of preferential treatment, and modify existing compliance processes to contemplate new books and records requirements, among other things. More fundamentally, advisers will need to re-evaluate the viability of many funds they sponsor under the new framework to determine whether the funds should or can continue and under what circumstances. The proposed short implementation timeline also would cause short-term contraction in the private funds markets as advisers focus on bringing their operations into compliance at the cost of raising new funds, and also would likely contribute to longer-term dislocation as advisers may need to further re-evaluate funds after the initial changes given the short deadlines under which they would be forced to operate in implementing the new rules. The Chamber believes that the transition period for the new rules, if adopted, should be no less than three years.

The Commission is increasingly allowing insufficient time for the public to comment on substantive changes in regulation. In addition, we encourage the Commission to consider how to stage compliance across the many new regulations to minimize inefficiencies for market participants.

Through several comment letters, CCMC has expressed its deep concern with the Commission's shortened and concurrent timeframes to respond to the wide array of new and complex proposals, most of which are recommending substantial technical changes to the reporting environment. We reiterate our concern with the Commission's plainly inadequate comment periods, especially if it is genuinely seeking meaningful feedback from stakeholders, and a general failure to consider the interconnected nature of these various proposals and the cumulative impact on private funds. We hope that the Commission will slow down the unprecedented pace of its rulemaking agenda in favor of getting the regulations right, keeping in mind that regulations should not only protect investors, but should do so in a way that maintains fair, orderly, and efficient markets and facilitates capital formation.

Additionally, given the Commission's very lengthy and fast-moving agenda, we are concerned about the extensive compliance changes that our member firms will have to make to implement the universe of new rules that are part of the Commission's agenda. The various rules under consideration will require layers of new systems, processes, and operations updates. Much in the same way that the Proposal will necessarily redirect Commission resources from the

protection of retail investors to the largest and most sophisticated investors in the world, the aggregate burden of coming into compliance with the Commission's fusillade of rulemaking will exhaust compliance department resources currently devoted to the identification and mitigation of actions that could harm investors. Has the Commission considered these updates collectively, specifically by conducting a thorough cost-benefit analysis of the cumulative impact of the Commission's various proposals? Moreover, has the Commission considered whether they could phase in new regulations and compliance requirements in a way that, considering the universe of proposals under consideration, is efficient for market participants to adopt? We hope the Commission will work in good faith to consider and develop implementation timetables that minimize the extensive burdens that will be placed on businesses as they comply with these many new regulations.

Conclusion

The Chamber welcomes this opportunity to comment on the Proposal. In its current form, the Proposal is unworkable for many private fund advisers. We stand ready to assist and be a resource for the Commission and the Staff.

Sincerely,

Kristen Malinconico
Director
Center for Capital Markets Competitiveness
U.S. Chamber of Commerce