**Managed Funds Association**
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels

June 13, 2022

**Via Electronic Submission**

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

**Re: Reopening of Comment Periods for "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews'' and ''Amendments Regarding the Definition of 'Exchange' and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities" (RIN: 3235–AN07; 3235–AM45; Release Nos. 34–94868; IA–6018; File Nos. S7–02–22; S7–03–22)**

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] submits these comments to the Securities and Exchange Commission ("**Commission**" or "**SEC**") to supplement our comment letter dated April 25, 2022 ("**April Comment Letter**"),[2] and in response to the Commission's reopening of the comment period for additional comment regarding the private fund adviser proposed rules ("**Proposed Rules**").[3] While we appreciate that the Commission has reopened the comment period on the Proposed Rules, we submit that additional time is necessary to seek quantitative

[1] MFA represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 member firms collectively manage nearly $2.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, Brussels, London, and Asia. www.managedfunds.org

[2] Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC (Apr. 25, 2022), available at: https://www.managedfunds.org/wp-content/uploads/2022/04/MFA-Comment-Letter-on-Private-Fund-Adviser-Proposal-with-Economic-Study-as-submitted-on-4.25.22.pdf.

[3] 87 Fed. Reg. 29,059 (May 12, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-05-12/pdf/2022-10195.pdf.

1301 Pennsylvania Ave NW, Washington, DC 20004 | 546 5th Avenue, New York, NY 10036 | Rue d'Arlon 40, 1000 Brussels, Belgium
ManagedFunds.org

data and address the numerous questions posed in the release for the significant changes to the private funds industry contemplated by the Proposed Rules.[4]

In the April Comment Letter, MFA explained that the Proposed Rules will fundamentally alter the fruitful, longstanding relationships between private funds and their sophisticated investors, particularly their ability to define the terms of their commercial relationship.[5] As we noted, the right to "shape that [adviser-client/investor] relationship by agreement, provided that there is full and fair disclosure and informed consent,"[6] is the decades-long hallmark of the Commission's regulatory approach to an investment adviser's fiduciary duty to its clients, including for private fund advisers and private funds.[7] We further identified how the Proposed Rules not only fail to address the Commission's stated objectives, but they also harm—rather than protect—investors in numerous ways by leading to increased fees, reduced investment opportunities and decreased competition in the private funds space.[8]

In this letter, we supplement the concerns articulated in the April Comment Letter by responding to certain requests for comment raised in the release accompanying the Proposed Rules ("**Proposal**").[9] In the first section, we address the Commission's request for comment on the effect of the Proposed Rules on efficiency, competition, and capital formation, by highlighting certain adverse unintended consequences of the Proposed Rules for investors. In the second section, we address various specific questions raised in the Proposal regarding the Proposed Rules, supplementing our response in the April Comment Letter. Finally, in the last section, we address the Commission's request for comment on the costs of the Proposed Rules by discussing the need for the Commission to consider the impact of all the rulemakings that the Commission has recently proposed that affect, directly or indirectly, private fund advisers *in the aggregate*.

---

[4] *See* March 1, 2022 letter from MFA and 11 other trade associations raising concerns regarding the insufficiency of comment periods for recent Commission rulemaking, including the Proposed Rules, available at: https://www.managedfunds.org/wp-content/uploads/2022/04/Extension-Request-File-Nos.-S7-03-22-S7-01-22.pdf, *and* Bipartisan Letter from Members of the U.S. House of Representatives to Gary Gensler, Chair of the SEC (Apr. 13, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20127548-288697.pdf.

[5] *See* April Comment Letter at 2.

[6] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669, 33,671 (July 12, 2019), available at: https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.

[7] *See* April Comment Letter at 2.

[8] *Id.* (noting that the Proposed Rules will significantly increase legal, regulatory, compliance, operational, and other costs, which will, among other things, create steep barriers to entry for new advisers, as well as lead to consolidation in the industry, thereby reducing diversification, competition, and the investment choices available to investors).

[9] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,886 (Mar. 24, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf.

## I. Effect on Efficiency, Competition, and Capital Formation

The Commission requests comment on whether it has accurately characterized the effects on competition, efficiency, and capital formation arising from the Proposed Rules.[10] In this section, we discuss certain of the adverse unintended consequences of the Proposed Rules for investors—including increased costs, reduced investing opportunities, reduced alignment of interest, and more limited negotiating ability for investors—especially in cases where adequate disclosure is entirely sufficient to address the issues identified by the Commission. These adverse unintended consequences have a direct impact on the Commission's analysis of the effect of the Proposed Rules on efficiency, competition, and capital formation. Many comment letters, including our April Comment Letter, identify other adverse unintended consequences of the Proposed Rules for investors that are relevant for the Commission's analysis but that are not addressed here.

### A. Prohibition on Reimbursement/Indemnification/Exculpation/Limitation of Liability for Breach of a Fiduciary Duty, Willful Misfeasance, Bad Faith, Negligence, or Recklessness

Under the Proposed Rules, an adviser to a private fund would be prohibited from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.[11] We understand the Commission believes such contractual terms harm investors by allegedly placing the adviser's interests above those of its private fund clients (and investors in such clients).[12] By limiting an adviser's responsibility for breaching the standard of conduct, the Commission believes that an adviser's incentive to comply with the required standard of conduct is eroded.[13]

As explained in the April Comment Letter, we disagree with the Commission on both of these contentions. We will not repeat the arguments set forth in that letter here,[14] other than to note that prohibiting advisers from seeking exculpation and indemnification for the types of conduct specified in the Proposed Rules is a significant departure from the industry standard of providing adviser exculpation and indemnification for losses other than those caused by the applicable adviser's gross negligence or willful misconduct, a departure which the Commission neither explains nor justifies.[15] Moreover, the Proposed Rules effectively impose a standard of

---

[10] Proposal at 16,960.

[11] Proposed Rule 211(h)(2)-1(a)(5).

[12] Proposal at 16,925.

[13] *Id.*

[14] *See* April Comment Letter at 13-20.

[15] *See* April Comment Letter at 20; *see, e.g.,* Letter from Joseph A. Grundfest, The William A. Franke Professor of Law and Business, Stanford Law School, to Vanessa Countryman, Secretary, SEC (Apr. 22, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20126231-286797.pdf (noting that the proposed prohibition on indemnification is an extreme outlier in terms of state and federal law).

care on private fund advisers in addition to the one that already applies under the Investment Advisers Act of 1940 ("**Advisers Act**"). Doing so in the manner set forth in the Proposed Rules will effectively impose a higher standard for private fund advisers than the one applicable to registered investment company advisers, which is incongruous, to say the least.[16]

Notwithstanding the inherent securities law incongruity of imposing greater restrictions on advisers to sophisticated investors than advisers to retail investors, we are strongly concerned that the prohibition on indemnification would have a number of adverse unintended consequences that would negatively impact investors in private funds, including pensions, foundations, and endowments.[17]

1. The indemnification prohibition will raise costs to advisers that likely will be passed on to investors

As discussed in greater detail in the April Comment Letter, the Proposal does not appear to consider the possibility that this prohibition will significantly increase the incidence and cost of actual and potential litigation related to private funds, which in turn will increase the costs borne by investors. In addition, and as the Commission correctly notes in the Proposal, advisers will be forced to increase their fees to compensate for both the risk and costs of such private lawsuits as well as other forms of potential liability related to the Proposed Rule (*e.g.*, trade and other errors that neither violate the existing standard of care nor industry standard liability provisions in advisory contracts). The Commission asserts that such fee increases will be "limited," but it does not (and indeed cannot) provide any evidence for this assertion.

In addition, the Commission asks whether the proposed prohibition on receiving indemnification or exculpation for negligence would cause an adviser's insurance premium to

[16] *See* Section 17(i) of the Investment Company Act of 1940 ("**Investment Company Act**") (only prohibiting a registered investment company from entering into an advisory agreement that "protects or purports to protect [the adviser] against any liability to such [investment company] or its security holders to which [the adviser] would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of [the adviser's] duties, or by reason of [the adviser's] reckless disregard of his obligations and duties under such contract or agreement.").

[17] The letters in the comment file overwhelmingly oppose this aspect of the Proposal, including letters from investors groups. *See, e.g.*, Letter from Institutional Limited Partners Association to Vanessa Countryman, Secretary, SEC (Apr. 22, 2022) ("**ILPA Letter**"), at 2, available at: https://www.sec.gov/comments/s7-03-22/s70322-20126586-287243.pdf ("While an ordinary negligence standard would in principle be welcomed by ILPA's members, we acknowledge the unintended consequences such a standard could impose, not least being the possibility that advisers' risk tolerance will be fundamentally impacted and potentially damage the returns produced by private funds."); Letter from Elizabeth L. Clark, Vice President, Policy and Research, National Association of College and University Business Officers, to Vanessa Countryman, Secretary, SEC (Apr. 25, 2022) ("**NACUBO Letter**"), available at: https://www.sec.gov/comments/s7-03-22/s70322-20126570-287231.pdf, at 3 ("A simple negligence standard of care likely will cause advisers to become reluctant to take the amount of investment risk necessary to obtain the level of returns consistent with historical private fund returns that our members and other institutional investors seek.").

increase.[18] As an initial matter, we note that this is the only reference to insurance that the Commission makes in this portion of the Proposal. If the Commission believes—as this question seems to imply—that insurance will adequately offset the increased costs and risks of liability imposed on advisers by the Proposed Rule, then it should say so directly and demonstrate why it believes this to be the case so that the public has a meaningful opportunity to comment. We think it would be important for the Commission to study the market for private fund insurance, including the cost and availability of such insurance for the types of risks that would be imposed by the Proposed Rule, or more broadly to understand how the applicable insurance policies work in practice and whether insurance coverage would even be available with respect to the increased risks imposed by the Proposed Rule. We are concerned that the Proposal fails to adequately consider how insurance, or the potential lack thereof following the Proposed Rule's adoption, will affect the costs and allocation of risks among advisers, insurance companies, and investors or how reallocation of risks will affect the alignment of interests among advisers and their investors.

Returning to the Commission's specific question about insurance costs, the answer is, categorically, yes, insurance premiums will increase materially. Because the Proposed Rule would significantly shift liability for certain types of costs and losses related to private funds to such funds' advisers, it only stands to reason that such advisers will see a significant increase in their insurance premiums. Of course, insurance companies will only provide coverage to the extent that it is profitable for them to do so. Accordingly, the increase in insurance premiums across the industry is very likely to equal to the sum of: (a) the expected costs and losses that the indemnification prohibition would transfer to advisers; (b) a premium to cover the unknown consequences of such a significant shift in liability inconsistent with longstanding industry practices; and (c) insurance company profit margins.

Many advisers already charge the costs of their insurance premiums relating to the management of their private funds to the private funds, and many more are likely to begin doing so following the substantial increase in these costs.[19] If the Commission is correct in its apparent belief that insurance policies will be available to absorb any incremental costs and losses shifted to advisers by the indemnification prohibition, then the result of this Proposed Rule will be that investors will end up bearing the same costs they did prior to its adoption (*i.e.*, the costs and losses that the rule purports to shift to advisers) plus increased costs associated with new, and unknown, risks and the profit margin charged by the applicable insurers. It is unclear why the Commission would issue a rule that, in practice, would primarily benefit insurance companies at the expense of investors. Moreover, this outcome calls into question the Commission's justification for this Proposed Rule (*i.e.*, that an adviser's incentive to comply with the required

[18] Proposal at 16,925.

[19] *See, e.g.*, NACUBO Letter at 3 ("Although it would appear that the proposed rules would reverse a trend of certain advisers attempting to transfer their regulatory compliance expenses to their private fund clients and investors, we are concerned that there will potentially be a material increase in fund expenses, insurance costs, and management fees as a result of the proposed rules.").

standard of conduct is eroded) since, in this scenario, any costs would continue to be borne by investors.

In reality, of course, it is unlikely that insurance will fully offset the increased costs and risks of liability imposed on advisers by the Proposed Rule. For one thing, we believe that the cost for advisers to obtain directors and officers, errors and omissions, and cost of corrections insurance, which have already become increasingly expensive in recent years, is likely to increase so significantly as a result of the Proposed Rule that obtaining adequate coverage will become non-economic for many advisers, whether or not they would be able to pass those costs through to the private funds they advise. It also is possible that insurers will simply be unwilling to offer insurance policies given the significant liability and uncertainty introduced by the Proposed Rule, or that individual advisers will become effectively uninsurable the first time they actually file a material claim.

The Proposed Rule also fails to consider certain important practical and contractual limitations on an adviser's ability to make claims under its insurance policies, including but not limited to (a) significant retention or deductible amounts (which are likely to increase further as advisers seek higher levels of overall insurance to offset the greater risks allocated to advisers by the Proposed Rule), (b) standard insurance industry exclusions from the types of losses that can be covered by insurance (*e.g.*, certain types of contractual breaches, certain reductions in the value of property), and (c) the requirement under most policies that someone (*e.g.*, an investor) must first assert a *bona fide* claim against the adviser before the adviser can make a claim on its insurance (*i.e.*, most policies do not permit an adviser to make proactive claims in the absence of an underlying dispute). Because the Proposed Rule will increase the risk that advisers will become subject to liabilities that may fit into one or more of these limitations, that advisers will have a powerful incentive not to reach amicable solutions with investors but rather to invite require litigation to demonstrate that the adviser is entitled to collect on its insurance contracts, a perverse outcome for all involved.

In all of the above circumstances, advisers will need to self-insure against a potentially significant amount of liability and expense, and many of them, whether they are large advisers or newer, smaller firms, simply will be unable to do so. This will not only reduce efficiency, competition, and capital formation—to the extent that many advisers will be forced to exit the private fund business due to their inability to self-insure—but it also will introduce significant risk and volatility for investors—to the extent that certain advisers will nevertheless elect to continue operating on an under-insured basis.

2. <u>The indemnification prohibition will decrease the alternative investment strategies and opportunities available to investors</u>

The Proposed Rule will fundamentally change the risk profile of advising private funds by subjecting private fund advisers to increased liability risks (*e.g.*, liability for trade and other errors or for certain types of investment-related losses), as well as heightened risk of meritless lawsuits. Regardless of whether advisers raise their fees to compensate for those increase risks, the Proposed Rule creates powerful incentives for such advisers to compensate in other ways, whether through offsetting changes to a private fund's governing documents (including changes to various non-economic provisions) and/or by engaging in behavior to reduce the risks of

liability, but with negative consequences to the private funds and their investors. The changes to the standard of care applicable to private fund advisers will discourage them from engaging in more complex and innovative strategies and activities where mistakes may be more likely. For example, advisers may avoid investing in distressed debt given the relatively greater likelihood that the adviser's investment decisions will be second-guessed in hindsight.[20] These unintended consequences are clearly contrary to the interests of private fund investors, who are well aware of the risks underlying the strategies deployed in their private funds and, in fact, invest in private funds expressly to gain exposure to the investment returns that are enabled by expert management and mitigation of such risks. Nevertheless, the proposed prohibition will deprive sophisticated investors of the ability to pursue such strategies by making their own determination as to risk-reward trade-offs.

By creating a disincentive for managers to engage in certain strategies and activities, there will be decreased competition and diversification, contrary to the intended purpose of the rulemaking. Furthermore, the indemnification prohibition will likely result in industry consolidation as smaller and mid-sized advisers will not have the scale and ability to absorb the increased costs created by the Proposed Rule. These unintended consequences are clearly contrary to the interests of private fund investors, but the Proposal fails to adequately consider them in its economic analysis.

3. The indemnification prohibition may cause private fund advisers to limit the number and type of investors they will accept

If private fund advisers will no longer be permitted to limit the ability of investors to litigate for perceived instances of negligence or breach of (state and non-U.S.) fiduciary duty, then private fund advisers will very likely consider limiting the absolute number of investors that they accept and/or restricting or excluding investment by certain types of investors that the adviser deems to create heightened litigation risk. Investors subject to the Employee Retirement Income Security Act of 1972 ("**ERISA**") are already subject to a similar dynamic in which their access to private funds is limited by many advisers to, in aggregate, 25% or less of any class of equity interests in a fund so that the adviser does not become subject to the heightened liability standard and other requirements of ERISA. The Proposed Rule is likely to have a similar, albeit potentially more dramatic effect on certain categories of investors. This consequence would be to the substantial detriment of investors, and, as such, should be considered in the Commission's economic analysis in a final rule.

[20] Consider the example of an investment in a portfolio company that does not work out. Investors who suffer market losses have a financial incentive to bring a lawsuit against an adviser to try to recoup their investment losses, exposing advisers to potential litigation risk even for normal market losses. The Proposed Rule significantly increases that risk as investors will be incentivized to bring lawsuits more frequently, whenever they believe they can sufficiently allege (in hindsight) that the adviser was negligent. A lawsuit that survives summary judgment, which may not be that difficult when alleging negligence, puts economic pressure on an adviser to resolve a claim, even if the adviser believes that the claim does not have merit.

### B. Prohibition on Charging Private Funds Certain Fees and Expenses

The Proposed Rule would prohibit a private fund adviser from charging a private fund fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority.[21] It also would prohibit a private fund adviser from charging regulatory or compliance fees and expenses of the adviser or its related persons to a private fund.[22] As a result of these prohibitions, among other things, advisers that use a pass-through expense model would be required to move to an alternate approach with respect to such fees and expenses.

As explained in the April Comment Letter, we do not believe the Proposed Rule should ban advisers from charging fees and expenses to clients when the fact that such fees and expenses are charged to clients has been fully disclosed and the client has consented to bearing those charges.[23] The Proposal fails to demonstrate that a pass-through expense model or the charging of specific expenses to private fund clients with appropriate disclosure, as compared to other types of fee arrangements, are not in the best interest of investors or somehow raise an inherent conflict. The Proposal also fails to address the inconsistency in prohibiting advisers to private funds from charging certain expenses to private fund clients when an adviser is permitted to charge a management or similar fee that could incorporate estimates of such expenses. Finally, the Proposal fails to address the fact that the performance compensation that most private fund advisers can earn already aligns the incentives of the adviser and investors and mitigates the potential conflict identified by the Commission.

In addition to the numerous problems with this Proposed Rule discussed in the April Comment Letter, we want to highlight below some of the unintended consequences of these prohibitions for investors.[24]

1. <u>The fee and expense prohibitions will disincentivize more transparent fee and expense arrangements</u>

Prohibiting pass-through expenses (which provide a high degree of transparency) and, more generally, encouraging advisers to pass certain types of expenses through to their investors in the form of management and other fees rather than directly seems inconsistent with the Commission's statements elsewhere in the Proposal regarding opacity in private fund structures. When passing their actual expenses to investors directly, advisers give investors a much better view into such expenses than when such expenses are passed on to investors indirectly through a management fee.

---

[21] Proposed Rule 211(h)(2)-1(a)(2).

[22] Proposed Rule 211(h)(2)-1(a)(3).

[23] April Comment Letter at 23. The letters in the comment file overwhelmingly oppose this aspect of the Proposal.

[24] The Commission should directly address the fact that if investors are not satisfied with the fees they are charged by a fund, they are free to invest in another private fund, a registered investment company, or some other investment vehicle.

2. <u>The prohibition will likely increase costs for investors</u>

This prohibition may have the unintended consequence of actually raising the overall costs to investors as advisers will need to increase or, in the case of pass-through advisers, begin charging management fees to cover their estimated costs. Instead of charging actual costs, advisers may charge fees that include amounts to cover unanticipated or uncertain future expenses. Thus, this prohibition could actually increase investor costs.

**C. Prohibition on Non-Pro Rata Expense Allocations**

The Proposed Rule would prohibit a private fund adviser from charging or allocating fees and expenses related to a portfolio investment (or potential 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, even if such allocation would be fair and equitable.[25] We understand that the Commission believes that "any non-pro rata allocation of fees and expenses under these circumstances is contrary to the protection of investors because it would result in the adviser placing its own interest ahead of an investor, including in circumstances where the adviser indirectly benefits by placing the interest of one or more clients or investors ahead of another's."[26] As we noted in the April Comment Letter, the Commission's characterization fails to consider a number of ways in which non-pro rata allocations can benefit investors.[27]

Accordingly, as discussed in the April Comment Letter, we believe the Commission should permit advisers to allocate fees and expenses when they reasonably believe those allocations are fair and equitable to clients. Failure to do so will create unintended consequences for investors.

1. <u>The prohibition could reduce invest opportunities or returns</u>

The prohibition on non-pro rata allocation of fees and expenses could have the unintended consequences of reducing investment opportunities and/or investment returns for private funds, leaving investors worse off than they are today in the absence of the Proposed Rule. For example, an adviser may offer an opportunity for investors to co-invest with a fund client because it will enable the fund to take a larger allocation of the investment opportunity. This may provide it with access to additional deals, enable it to negotiate better terms, or arrange more favorable financing with respect to a deal than if the fund client were investing alone. Even if such co-investors are not willing to pay the same costs and expenses as the fund client, the benefits to the fund client of increased investment opportunities and/or better terms on its

[25] Proposed Rule 211(h)(2)-1(a)(6).

[26] Proposal at 16,926.

[27] *See* April Comment Letter at 28-29.

investments can more than offset any costs that the fund is required to bear on behalf of such co-investors.[28]

2. A pro rata allocation may lead to inequitable results in certain cases

To take just one of many possible examples, an instance in which an overly broad application of the prohibition on non-pro rata allocation may have unintended consequences for investors relates to fees and expenses that occur at different times due to investments occurring at different times. A private fund may incur research costs in connection with a particular investment, and then use the same research in the future for another client in connection with a different investment. In this case, allocating expenses across clients at the time of the initial research may be the most equitable allocation method, when viewed over time. To take another example, while it may make sense to allocate fees on a pro rata basis when two funds invest in the same security, it may not make sense when the funds invest in different parts of the capital structure of a company.

3. Prohibiting non-pro rata allocations may create significant barriers to entry for smaller and newly formed advisers

The proposed prohibition is likely to create significant barriers to entry for smaller and newly formed investment advisers. In addition to potentially increasing their costs in absolute terms and creating disincentives to the incurrence of certain types of costs that benefit their investors, as outlined in the April Comment Letter, this prohibition also will make it more difficult for such advisers to attract the seed capital necessary to start and maintain their businesses. Seed and other large investors may, among other things, require investment rights as a condition to their investment (*e.g.*, to drive down their blended fee), and may refuse to bear certain expenses, such as broken deal expenses, in connection with such rights (as co-investors commonly do). If the manager cannot allocate such investor's pro rata share of these co-investment expenses to other participating funds (with full and fair disclosure), it will have to bear such investor's share out of pocket, which is a significant economic burden for a start-up manager operating with tight margins and limited resources, which may disproportionately impact women and minority-owned advisers.

### D. Prohibition on Preferential Treatment Regarding Liquidity Terms

The Proposed Rule would prohibit all private fund advisers from providing an investor in a private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that

[28] *See* Letter from Ohio Public Employees Retirement System (OPERS) to Vanessa Countryman, Secretary, SEC (Apr. 25, 2022), at 9, available at: https://www.sec.gov/comments/s7-03-22/s70322-20126471-287115.pdf ("**OPERS Letter**") ("OPERS is concerned that the SEC's proposed prohibition on certain non-pro rata fee and expense allocations could inequitably impact co-investors that invest alongside another fund managed by the same GP. To the extent the SEC believes it must address non-pro rata allocations of fees and expenses, we respectfully request that it considers a more nuanced solution than a blanket prohibition, including allowing flexibility in co-invest situations where such allocations may make sense for the fund and its investors.").

private fund or in a substantially similar pool of assets.[29] We assume here that the Commission intended to limit the scope of arrangements that are subject to the proposed prohibition to arrangements agreed to with investors outside of the four corners of a private fund's governing documents, for example, in side letters.[30] We believe that the Proposed Rule is fundamentally flawed in several respects and, if adopted, would harm rather than protect investors. This is a view shared by a number of investor groups that commented on the Proposed Rules, including state investment agencies.[31]

The following are some of the unintended consequences of the preferential treatment prohibition.

1. The prohibition may prevent some private fund advisers from attracting additional investors

Private funds and investors alike derive benefits from offering preferential treatment to particular investors, such as attracting additional investors, spreading fees and expenses across a larger asset base, and achieving a capital base that is sufficiently large to optimally pursue a fund's investment strategies, even when one or more investors negotiate to obtain preferential redemption rights. However, the prohibition on offering preferential treatment regarding liquidity terms may discourage certain investors from making an investment in a fund, thus harming both the fund and its investors. Consider just a few examples of investors that may need to negotiate for preferential withdrawal rights:

- Public plans and other investors that require such rights in the event of a change in law applicable to their investment, a change in their tax status or other adverse tax consequence caused by such investment, and/or other similar matters;
- Investors that are subject to limitations on the percentage of a fund that they may constitute or on the types of investments they are allowed to make (*e.g.*, specific environmental, social, and governance ("**ESG**") requirements, limitations or

[29] Proposed Rule 211(h)(2)-3(a).

[30] *See* April Comment Letter at 31-32.

[31] *See, e.g.*, Letter from Minnesota State Board of Investment ("SBI") to Vanessa Countryman, Secretary, SEC (Apr. 22, 2022), at 1, available at: https://www.sec.gov/comments/s7-03-22/s70322-20126728-287433.pdf ("For governmental investors like the SBI, preferential treatment is at times necessary to address specific legal and policy requirements put in place to protect or enhance the benefits to the public pension plans and other public programs that SBI serves. For instance, an outright prohibition on preferential redemption rights could contravene state laws or policies that require redemption or withdrawal under specified circumstances."); OPERS Letter at 8 ("Investors like OPERS utilize the side letter process to negotiate individual terms and different treatment . . . that help tailor and mitigate its risks. If OPERS is unable to protect itself by negotiating these necessary terms, it could be forced to walk away from a fund, which carries its own risks, including missing out on increasingly limited opportunities to deploy capital.").

prohibitions on investments in certain industries, and requirements adopted pursuant to divestment or other similar statutes);

- An investor that is a bank holding company and that therefore may not be able to own more than 25% of a fund;
- An investor that is subject to ERISA and may not be able or may wish not to invest in a fund where aggregate benefit plan investor participation exceeds the 25% threshold described above;
- Registered investment companies and their affiliates, who may be subject to adverse consequences under the Investment Company Act (including Section 17 thereof) if they exceed certain ownership thresholds in a fund;
- Non-U.S. investors who may be subject to adverse consequences (and whose participation may subject the applicable fund to adverse consequences) if their investment in a fund exceeds certain thresholds under rules administered by the Committee on Foreign Investment in the United States ("**CFIUS**"); and
- Investors that seek withdrawal rights in the event that their participation in the fund is required to be disclosed publicly or otherwise.

Such triggering events may occur after an investor has made its initial investment in a fund as well as for reasons that are outside of either the investor's or the adviser's control. In other cases, an adviser may determine, for example, to cause the fund to cross a threshold applicable to a particular investor because doing so would be in the best interests of the fund as a whole. In all of these cases, we believe both that it is reasonable for an adviser to agree to give the applicable investor preferential liquidity rights and that such rights (whether or not they are exercised ultimately) are very unlikely to harm other investors. However, because the standard included in the Proposed Rule is unclear and subject to second-guessing in hindsight, the Proposed Rule creates significant disincentives for advisers to accommodate requests that, for many investors, are a prerequisite for their investment.

2. The prohibition may create significant barriers to entry for smaller and newly-formed advisers

Prohibiting preferential redemption rights may also limit the availability of seed capital. Some investors may require preferential redemption rights as a condition of seeding a fund. This prohibition is likely to create significant barriers to entry for smaller and newly-formed investment advisers (including women and minority-owned advisers), which will be significantly impacted by prohibitions that make it harder to attract anchor and seed investors that are essential to getting a fund started.[32]

---

[32] *See* Letter from Anastasia Titarchuk, Chief Investment Officer and Deputy Comptroller for Pension Investment and Cash Management, Comptroller of the State of New York, to Vanessa Countryman, Secretary, SEC (Apr. 25, 2022), at 10, available at: https://www.sec.gov/comments/s7-03-22/s70322-

3. The prohibition may limit the ability of investor to meet their individual needs

There are a range of benefits for investors from the ability to negotiate liquidity terms that meet their individual needs. For example, certain types of investors, including many public pension plans, may be required to divest from funds that pursue certain types of investments or may have portfolio concentration or other risk limits that require them to withdraw or redeem all of or a portion of their investment in a private fund. By preventing such investors from negotiating for redemption rights in these circumstances, the Proposed Rule may pose a significant hinderance on investors from pursuing private fund investments more generally.

## E. Prohibition on Preferential Treatment Regarding Information Rights

The Proposed Rule would prohibit a private fund adviser from providing an investor with information regarding the portfolio holdings or exposures of the private fund, or of a substantially similar pool of assets, to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.[33]

This proposed prohibition is likely to have significant adverse effects on investor transparency.

1. The prohibition may prevent private fund advisers from accommodating specific information requests from investors

Private fund advisers often provide more detailed holdings/exposure information to specific investors because those investors find this information to be crucial for their own portfolio management purposes (*e.g.*, to look at all of their outside investments in a similar manner or to look for unintended risk exposures across their entire portfolio). Other investors need specific information to meet their compliance and other obligations under state or local laws or regulations.[34] In other words, investors do not want one-size-fits all, homogenized

20126603-287255.pdf ("New managers often offer initial investors and anchor investors preferential rights and economics to secure a large commitment early on as a foundation for their remaining fundraising. This practice benefits the adviser by securing a sizable commitment for their fund and benefits the investor by compensating it for the risk of engaging a new adviser. To the extent the proposed rules prohibit or discourage providing preferential rights to investors, it could significantly dampen investors' ability to underwrite such investments and emerging manager access to much needed seed capital.").

[33] Proposed Rule 211(h)(2)-3(a)(2).

[34] *See, e.g.,* Letter from Marcie Frost, Chief Executive Officer, California Public Employees' Retirement System, to Vanessa Countryman, Secretary, SEC (May 3, 2022), at 3, available at: https://www.sec.gov/comments/s7-03-22/s70322-20127881-289394.pdf ("We are concerned that the Proposal's facts and circumstances standard for determining material, negative impacts for preferential redemption rights or transparency may impede limited partners' ability to negotiate for certain side letter terms. We urge the Commission to provide greater specificity as to the nature of terms deemed to have a material, negative impact on other investors in the same fund. Further, we request that the SEC clarify

information, but rather information that is tailored to their specific needs, which current market practice allows.

Because advisers would be subject to being questioned in hindsight as to whether they should have expected a negative outcome for other investors, they likely will determine that the prudent course of action is to eliminate investor-specific reports. This outcome is made more likely because, while the Proposed Rule only prohibits preferential information rights when the adviser "reasonably expects that providing the information would have a material, negative effect on other investors," this creates a vague standard that would be difficult for advisers to rely on as a basis for concluding *ex ante* that particular information shared with an investor is not prohibited by the Proposed Rule. As a result, advisers may no longer be able to accommodate specific information requests, as the burden of giving the information to all investors may simply be too great, particularly if information is given orally—*i.e.*, making that type of information widely available would require the adviser to prepare numerous formal reports.[35]

We are concerned that the likely result is that investors will no longer get the type of information that they find most useful and that providing sensitive information to larger groups of investors raises concerns about the information becoming public, harming the fund and its investors.

2. The prohibition may impede the ability of investors to conduct adequate due diligence on private fund advisers

Institutional investors generally conduct extensive due diligence on a private fund adviser both before determining whether to invest with the adviser and subsequent to investing with the adviser. However, the prohibition on advisers providing preferential information is likely to chill the free flow of information between an adviser and its investors for the reasons stated above, as the prohibition significantly increases an adviser's risk in responding to one-off information requests. To take just one example, while diversity, equity, and inclusion ("**DEI**") and ESG questions have become commonplace, the Proposed Rule will frustrate investors' ability to obtain information regarding such matters, both because they may be prohibited from receiving such information to the extent it relates to the portfolio holdings or exposures of the private fund and, if such information relates to other matters, because the adviser may determine that disclosure would be too costly in light of the advance disclosure requirements proposed in

that this rule does not prohibit investors from entering into bespoke arrangements with private fund advisers to secure essential institution-specific requirements.").

[35] It is easy to imagine just how problematic such a prohibition could be. Imagine a scenario whereby an institutional investor is conducting diligence on a fund investment. Such meetings are often granular in nature and driven by the interests of the investor or prospective investor. If the investor asks a question in the meeting, would the adviser need to consider whether it can respond at all? Thereafter, would the adviser need to take stock of everything discussed at the meeting, compare it to otherwise disclosed information to all other investors, and, thereafter, make a determination about whether to make additional disclosure? Such a process is burdensome and unworkable to the point that advisers are very likely to not respond to many requests for information or questions from investors, which will necessarily impact the investor community negatively.

Section 211(h)(2)-3(b) of the Proposed Rule (which we have not otherwise separately addressed in this letter). As a result, investors will find it materially more difficult to obtain the information that they need, both prior and subsequent to investing in a private fund.

## II. Additional Requests for Comment

In the following section, we discuss in more detail than in the April Comment Letter certain of the requests for comment and certain of the additional questions posed by the Commission in the Proposal.

### A. The Commission Lacks Authority to Impose Prohibitions or Substantive Restrictions on Compensation Arrangements with Private Fund Clients

The Proposal includes a number of questions seeking input on whether the Commission should consider further restrictions or prohibitions on the compensation arrangements that advisers can enter into with clients, including private funds. In our view, the Commission lacks authority to impose prohibitions or substantive restrictions on compensation arrangements between an adviser and its private fund client.

Congress, on a number of occasions, has specifically spoken with respect to the issue of investment adviser compensation in enacting and amending Section 205 of the Advisers Act, including explicit exclusions from limitations with respect to certain private funds. As the Commission is aware, Section 205(a)(1) generally prohibits registered investment advisers from entering into or performing an investment advisory contract if the contract provides for compensation "on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client." Similarly, Section 205(b)(2) prohibits an investment advisory contract with a registered investment company from including such a performance fee, unless the fee is averaged over a specified period and increases or decreases proportionately based on the investment company's performance relative to the performance of an appropriate securities index (a so-called fulcrum fee). Section 205(b)(3) of the Advisers Act provides a statutory limitation on the amount of performance-based compensation that an advisory contract with a business development company ("**BDC**") may include, as well as imposing limitations on the structure of such performance compensation (an advisory contract with a BDC may provide a performance-based fee up to 20 percent of the realized capital gains of the BDC over a specified period, computed net of all realized capital losses and unrealized capital depreciation).

Sections 205(a) and (b) clearly demonstrate that Congress has established the circumstances in which investment adviser compensation should be subject to limitations, and Congress has chosen not to impose limitations on the compensation arrangements between investment advisers and their private fund clients. In fact, Section 205(b) provides that the restriction in Section 205(a)(1) shall not apply in certain specified circumstances, including with respect to an advisory contract with a private fund that is excepted from the definition of investment company under Section 3(c)(7) of the Investment Company Act.

Further, when Congress adopted the National Securities Markets Improvement Act ("**NSMIA**") in 1996, it added Section 205(e) to the Advisers Act. Section 205(e) provides that

the Commission may exempt any person or transaction, or any class or classes of persons or transactions, from the restriction in Section 205(a)(1) any person that

> does not need the protections of subsection (a)(1), on the basis of factors such as financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the Commission determines are consistent with this section.

In enacting NSMIA, Congress specifically concluded that investors in private funds do not require the same types of protections as investor in registered investment companies, finding "financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections. Generally, these investors can evaluate on their own behalf matters such as the **level of a fund's management fees**, governance provisions, transactions with affiliates, investment risk, leverage and redemption rights" (emphasis added).[36] Accordingly, in adopting NSMIA, Congress clearly determined that private funds should not be subject to limitations regarding the compensation that is paid to a private fund adviser.

Congress in 2008 again spoke to the issue of investment adviser compensation in Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**"), which required the Commission to adjust for inflation any dollar amount test in making a determination under Section 205(e) of the Advisers Act. As with prior legislation, the Dodd-Frank Act clearly demonstrated Congress' view that sophisticated investors should not be subject to limitations on the amount of or method for calculating compensation.

This longstanding legislative history of Section 205 of the Advisers Act makes clear that the compensation an investment adviser charges private funds should not be subject to regulatory limits on the amount or structure of such compensation. Any attempt by the Commission to overrule this clear Congressional determination through agency rulemaking would exceed the authority granted to it by Congress.

In addition to the clear legislative framework applicable to investment adviser compensation, the Commission has a longstanding history with respect to rulemaking under Section 205 of the Advisers Act that demonstrates sophisticated clients should not be subject to compensation limits. In 1985, the Commission adopted Rule 205-3 under the Advisers Act to exempt advisory contracts with "qualified clients" from the compensation restriction in Section 205(a)(1).[37] Subsequent to the enactment of Section 205(e), the Commission has amended Rule 205-3 four times, most recently in 2021. In each of these rulemakings, the Commission has established, and reaffirmed, that sophisticated investors are capable of deciding for themselves

---

[36] S. Report 291, 104th Cong. 2d Sess., at 10 (1996).

[37] Prior to the adoption of NSMIA, the Commission relied on its general exemptive authority to issue Rule 205-3.

the amount of compensation, and the method by which such compensation is determined, that they are willing to pay.

The Commission has not provided any justification to overcome the clear statutory framework regarding adviser compensation, nor to justify what would be a substantial departure from existing Commission policy with respect to compensation arrangements between investment advisers and private fund clients.[38] As such, we believe that Commission rulemaking to impose limits on the amount of compensation or method by which advisers charge private fund clients is not supported by the Advisers Act and also would represent an unreasonable departure from the Commission's longstanding policy and practice with respect to compensation arrangements with sophisticated clients.

### B. Prohibitions or Restrictions on Compensation Arrangements Will Have Adverse, Unintended Consequences for Investors

In addition to the fundamental concerns regarding the Commission's authority to impose prohibitions or substantive limits on the compensation arrangements between investment advisers and sophisticated clients (such as private funds), we believe that attempts to set regulatory limits on compensation arrangements with private funds would have a number of unintended consequences. These consequences include limiting investor choice as advisers likely would adjust the investment strategies they are willing to provide or decide to no longer provide services to third-party clients (as opposed to trading for its own account) if the compensation that advisers can earn no longer justifies the costs and risks associated with their business model. Regulatory restrictions on compensation also fail to appropriately consider the diversity of asset managers and the need for advisers to be able to tailor their compensation arrangements in light of their business needs.

Performance-based compensation in private funds is structured to align the interests of the private fund adviser and investors in the fund, which is a valuable benefit to investors and one that is typically sought by sophisticated investors through their negotiation of economic terms. Prohibitions or restrictions on performance-based compensation are likely to disrupt this alignment of interest to the detriment of investors. Given the wide range of fund strategies, investor liquidity rights, and nature of fund assets and a common desire for managers to further align the interests of the adviser and investors through compensation of adviser employees that relates to the performance-based compensation earned by the adviser, it is critical for advisers to have flexibility in structuring their performance-based compensation.

Management fees, or other forms of asset-based compensation, also are designed to achieve important objectives that benefit investors. These compensation arrangements typically provide a more reliably consistent way for advisers to pay their fixed and other costs, compared

[38] *See Goldstein v. SEC,* 451 F. 3d. 873, 883 (DC Cir. 2006) (finding that the Commission failed to adequately justify departure from its own prior interpretation of the definition of "client" for purposes of Section 203(b)(3) of the Advisers Act, citing *Northpoint Technology, Ltd. v. FCC,* 412 F.3d 145, 156 (D.C. Cir. 2005) ("A statutory interpretation . . . that results from an unexplained departure from prior [agency] policy and practice is not a reasonable one.")).

to performance-based compensation arrangements, and allow advisers to effectively allocate resources to pay for important functions (*e.g.*, legal and compliance functions) during periods when the adviser may earn little, or no, performance-based compensation. Ensuring that advisers have sufficient resources for these functions provides significant value to investors, who often spend significant time assessing the quality of an investment adviser's operational functions as part of their diligence process. Prohibitions and pre-established limitations on adviser compensation will likely have the unintended consequence of making it difficult for advisers to structure their compensation to be able to provide the quality of operations that sophisticated investors expect.

We strongly encourage the Commission not to proceed with rulemaking that would prohibit or place limits on compensation arrangements beyond those set out in Section 205 of the Advisers Act. To the extent the Commission has concerns regarding compensation arrangements between advisers and sophisticated clients, the Commission should focus on ensuring that compensation arrangements have been appropriately disclosed to such clients and that compensation practices are consistent with such disclosures.

### C. The Commission Provides No Basis for Substantive Restrictions or Prohibitions on Private Fund Compensation Arrangements

As noted above, the Commission has not provided any basis to change the longstanding regulatory framework regarding compensation arrangements between investment advisers and sophisticated clients, such as private funds. In particular, the Commission has not identified any market failures—and indeed has not compiled any factual record at all—that might justify such a fundamental change in the regulation of compensation arrangements. To the extent that the Proposal considers fee arrangements at all, it seems to acknowledge that market practice varies,[39] thereby demonstrating that private fund investors and advisers can and do negotiate compensation arrangements in a competitive marketplace (both as to type and amount) and that investors have a range of compensation options to choose from when deciding whether to invest in, and remain invested in, private funds. The lack of a factual or policy basis identified by the Commission, together with the clear legislative and regulatory framework and unintended consequences discussed above, clearly demonstrates that the Commission should not consider proposals to impose any of the restrictions or prohibitions discussed below.

### D. Responses to Specific Questions in the Proposal

1. Should we establish maximum fees that advisers may charge at the fund level?

In response to the Commission's question, we believe the Commission should not establish maximum fees that advisers may charge at the fund level. Advisory fees are negotiated between advisers and fund investors and reflect a range of business considerations, including the costs for an adviser to provide its services and the risks to the adviser in connection with providing its services. The costs and risks for different investment advisers differ materially

[39] *See* Proposal at 16,893 ("We believe requiring advisers to disclose all forms of adviser compensation as separate line items (without prescribing particular categories of fees) is appropriate because it would encompass the various forms of adviser compensation across the private funds industry.").

based on, among other things, the size of the adviser, the investment strategy the adviser implements, the risk management, compliance, and back-office functions of the adviser, and the extent to which the adviser outsources certain functions or performs those functions in-house. Given the different business needs, costs, and risks of different advisers, any maximum fee would be arbitrary in nature and, therefore, inappropriate for Commission rulemaking.

Adviser costs can vary significantly not only from firm to firm, but also from year to year. Accordingly, imposing compensation caps could be both extremely disruptive to private fund advisers' ability to manage their costs and spend the resources they believe appropriate (including compliance and operational costs) to operate their business, which could be highly destabilizing for such advisers and the funds they manage. This could have significant adverse consequences on investors.

Furthermore, investment advisers negotiate the fees that they charge based on market conditions, competitive advantages they may have relative to other advisers, and the compensation they believe is worth the time, costs, and risks associated with acting as an investment adviser to third parties. Setting a maximum fee that advisers are permitted to charge would place artificial limits on advisers whose performance enables them to charge higher fees than other firms in an open and competitive market. For some successful advisers, compensation limits may lead them to conclude that the time, costs, and risks associated with managing assets for third parties outweighs the benefits leading them to choose to become family offices or otherwise manage only their own assets going forward.

In addition, the Commission must recognize that investment advisers compete for professional talent not just with other investment advisers, but also with other financial services firms and non-financial services firms (*e.g.,* technology companies) that are not subject to similar restrictions on compensation (or not subject to restrictions on compensation at all). Artificial limits on the compensation that investment advisers can earn will have effects on the compensation that advisers can pay to their employees. This impact on adviser employees likely will lead to talented professionals deciding not to work in the asset management industry, ultimately harming investors who will lose access to talented professionals. Importantly, the risk of loss of talent extends beyond portfolio managers and would include research analysts, risk managers, information technology and cybersecurity professionals, and legal and compliance professionals, among others, who perform key functions at investment advisers.

2. <u>Should we prohibit certain compensation arrangements, such as the "2 and 20" model?</u>

In response to the Commission's question, we believe the Commission should not prohibit compensation arrangements that investment advisers and private fund investors have agreed to, including a model that incorporates both a management fee and a performance-based fee (or allocation). As discussed above, the management fee component and performance-based fee component of a compensation arrangement are designed to accomplish different objectives that are beneficial to private fund investors, and banning the model would negatively affect the value of services that advisers provide.

Management fees can provide an adviser with a more reliable and steady way to pay for the fixed and other costs associated with providing its advisory services to clients. Many investment advisers use management fees to pay for various operational functions, such as legal and compliance, fund administration, and fund accounting. Management fees can be particularly important for newer and smaller investment advisers to pay for their recurring costs, though many established, larger investment advisers also rely on management fees to pay those costs.

Performance-based compensation permits advisers to further align their interests with investor interests, as advisers with performance-based compensation earn those fees only when clients earn agreed-upon returns on their investments. This is particularly the case because the performance-based fees that can be earned by most private fund advisers are subject to one or more of the following limitations designed to align adviser and investor interests: high-water marks, hurdle rates, multi-year performance periods, and/or clawbacks. Performance-based compensation also allows investment advisers to attract and retain high quality investment and other professionals by permitting those professionals to benefit when the adviser successfully generates positive investment returns for investors. Alignment of interests and the ability to attract and retain quality professionals is beneficial for investors, who typically negotiate for compensation arrangements that achieve these shared objectives.

Moreover, as discussed above, Section 205(b)(3) of the Advisers Act specifically provides that investment advisers may charge BDC clients a performance-based fee. Investment advisers to BDCs also typically charge a management fee for their advisory services. Unlike private funds, exchange-listed BDCs are marketed and sold to retail investors. We do not see—and the Commission has not provided—any policy basis on which the Commission reasonably could prohibit advisers to private funds from charging management fees and performance-based fees, when the Advisers Act specifically permits similar fee arrangements for BDCs.

3. Should we prohibit advisers from receiving compensation from portfolio investments to the extent they also receive management fees from the fund?

In response to the Commission's question, we believe the Commission should not prohibit investment advisers from receiving compensation from portfolio investments. Investment advisers, like other businesses, can provide a variety of services to different customers and clients and should have the right to be compensated for providing services to each of its customers. In the context of providing services to portfolio investments, investment advisers can provide significant value to those portfolio companies, for example, by serving on the board of directors, providing valuable consulting advice that can help a company set and achieve growth objectives, or upgrading a company's information technology to help a company become more efficient or secure. An investment adviser should have the right to be compensated for providing those services, the same as any other business would if it provided similar services to the company.

An adviser that is capable of providing services to a portfolio company that enhance the business prospects or value of the company creates value for the adviser's clients as well. To the extent advisers are not permitted to be compensated when providing services to portfolio companies, they are less likely to provide those services, in whole or in part. This result would

deprive the company and the adviser's clients that own interests in the company of the value that the adviser otherwise could have provided.

4. Should we impose limitations on management fees (which are typically paid regardless of whether the fund generates a profit), but not impose limitations on performance-based compensation (which is typically tied to the success of the fund)?

In response to the Commission's question, we believe the Commission should not impose limitations on management fees. As discussed above, management fees and performance-based compensation often are designed to achieve different objectives, and provide different benefits to clients. Management fees often are intended to pay for the fixed and other costs of the adviser related to providing advisory services to clients, such as legal, compliance, and operational functions of the adviser. While management fees can and do fluctuate (as assets under management change), they are a more predictable way for advisers to pay such costs than performance-based compensation. Clients benefit from knowing that an adviser has a reliable way to pay for these functions, even in years when an adviser does not generate performance-based compensation (which we note can occur even if the adviser generates profits for clients in a particular year because of compensation structures like hurdle rates or multi-year periods for determining performance-based compensation). Furthermore, for new managers with a single fund and back-ended performance based-compensation, it may be difficult to attract talent and build infrastructure since there will be no source of revenue to pay these costs for multiple years (if ever).

5. Should we prohibit management fees from being charged as a percentage of committed capital and instead only permit management fees to be based on invested capital, net asset value, and other similar types of fee bases?

In response to the Commission's question, we believe the Commission should not prohibit management fees from being charged as a percentage of committed capital. Private funds that use capital commitment structures typically require investors to meet capital calls when the investment adviser believes it can beneficially invest that capital in a relatively short period of time. By calling capital close in time to when an investment with that capital is expected to be made, investors do not have their capital tied up for extended periods of time when that capital cannot be invested productively. In order to effectively and efficiently call capital from investors, investment advisers need to commit significant resources to identifying potential investments prior to the capital being called. Charging management fees on committed capital helps ensure that the investment adviser has sufficient resources to pay for the costs associated with both existing and future investments. Investors agree to such an arrangement because they recognize that: (1) the arrangement helps to align the interests of the adviser and investors by removing an incentive for the adviser to call capital prior to the time when the capital can be invested in a productive manner; and (2) the investment adviser is providing services and spending resources not just on capital that has been invested, but also on future investments that will be funded out of committed, but not yet called capital, and should be compensated for those services.

On the other hand, prohibiting investment advisers from charging management fees based on committed capital would create incentives to structure their funds to require all capital to be immediately invested in the fund, even if the fund is not able to quickly invest all of that capital in a productive manner. For funds that continue to use capital commitments, investment advisers would have an incentive to call capital earlier in the investment timeline to be compensated for the work the adviser is doing for future investments. Each of these would be an adverse outcome for fund investors, whose interests are better served by having their capital called only when the investment adviser believes that it is able to invest that capital in productive assets.

Further, prohibiting investment advisers from charging management fees on committed capital also could create funding or resource issues, particularly for smaller and newer advisers, who are less likely to have other resources from which to pay for the adviser's expenses related to future investments for which investor capital has yet to be called. This will create significant barriers to entry for smaller and newer advisers, reducing competition and limiting investor choices.

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

In response to the Commission's question, we believe the Commission should not prohibit deal-by-deal waterfall arrangements. The use of so-called "American waterfalls" helps ensure that both investors in a fund and the general partner or investment adviser of the fund can receive distributions during the operation of the fund, which can reduce the risks for managers associated with operating for long periods of time without generating revenue. Those risks can include the loss of (or inability to hire) talented professionals who may choose employment arrangements with other advisers (or employers other than asset managers) that are able to provide the employee with more regular income streams.

Because funds structured with this type of distribution typically provide a clawback feature that is designed to ensure that the total performance compensation paid to the fund's general partner or investment adviser does not exceed the amount set out in the fund's offering documents, investors are protected from overpayment risk. The distribution arrangement reflects a negotiated agreement between sophisticated investors and private fund advisers that is designed to address the business needs of the adviser and protect the investor from overpayment of performance compensation. The arrangement also helps to align the interests of the adviser and investors by more closely linking the timing of distributions to each party.

Prohibiting these compensation arrangements could disrupt this alignment of interests between an adviser and fund investors. A prohibition also is likely to significantly affect smaller and newer managers who are more likely to need to generate regular cash flows to pay for their ongoing expenses, including professional staff.

7. We recognize that clawback mechanisms are more common for closed-end funds and less common for open-end funds. Should the rule separately address performance-based compensation for open-end private funds? If so, how should we address those funds?

In response to the Commission's question, we believe the Commission should not consider other rules that impose clawback mechanisms or other restrictions on performance-based compensation arrangements in open-end private funds for all of the reasons discussed above.

In addition, in open-end private funds, investors and advisers are similarly situated in that they each typically have the ability to benefit from both realized and unrealized performance of the applicable private fund. Advisers benefit in the form of performance-based compensation that is computed at periodic intervals based on the increase or decrease of the applicable fund's net asset value during the applicable period, and investors benefit to the extent that they are free to withdraw from the fund on the basis of this same net asset value (*i.e.*, they likewise benefit from both realized and unrealized performance of the underlying portfolio). However, to the extent that an adviser subject to a high-water mark provision is paid or receives a performance fee or allocation in one period but the applicable private fund subsequently experiences losses, such adviser typically would be required to earn back such losses, in whole or in part, before it could earn any further performance compensation (subject to the relevant investors electing to remain invested in the applicable fund). In this manner, the high-water mark aligns the incentives of advisers and investors and provides an appropriate mechanism for protecting investors' interests.

However, investors are subject to no similar obligation; that is, when an investor withdraws from a fund but one or more unrealized positions held by the fund at the time of such investor's withdrawal subsequently depreciate, there typically is no obligation for the withdrawing investor to return such excess amount. Moreover, establishing a clawback or other similar mechanism applicable to advisers under these circumstances would in effect amount to a requirement that: (a) advisers subsidize withdrawing investors out of their own pocket in the event of any subsequent depreciation in unrealized positions (an outcome for which there can be no reasonable justification) or (b) withdrawing investors become subject to a performance clawback. Because investors are highly unlikely to agree to such a clawback, the practical consequence is very likely to significantly reduce investor liquidity (since many funds would only permit withdrawals based on realized investments, with de facto side pocketing of an investor's share of any unrealized positions) or perhaps even more fundamentally imperil the open-end nature of open-end funds.

Given the sophisticated nature of private fund investors and the competition in the market to choose among a wide range of advisers with different compensation arrangements, there is no policy basis for imposing regulatory restrictions on performance-based compensation for open-end private funds.

8. Should the proposed rule exclude certain activity from the prohibition (*e.g.*, scenarios where a private fund makes tax advances or tax distributions to its general partner (or similar control person) to ensure that the general partner and its investment professionals are able to pay their personal taxes derived from the general partner's interest in the fund? If so, what activity should we exclude and why?

In response to the Commission's question, we believe the Commission should exclude from the prohibition scenarios where a private fund makes tax advances or tax distributions to its general partner (or similar control person) to ensure that the general partner and its investment professionals are able to pay their personal taxes derived from the general partner's interest in the fund. As discussed in the April Comment Letter, such advances are used for legitimate operating purposes, namely, to pay tax liabilities in respect of performance fees or allocations, or "carry," that have accrued to the general partner but which have not yet been paid. Frequently, such tax liabilities arise prior to the general partner's entitlement to a cash distribution (*i.e.*, a "phantom" tax liability). The risk of a tax liability incurred without a current distribution (and insufficient cash or assets to cover the liability) is likely to be overwhelmingly borne by smaller and newly formed advisers. At the same time, the Commission is actively seeking comment on whether it should prohibit deal-by-deal waterfall arrangements in an apparent preference for "back-ended" carry arrangements, which would substantially increase the likelihood of phantom tax liabilities. We firmly believe that tax advances do not present the conflicts-of-interest which the Proposed Rules were intended to address. Importantly, tax distributions are typically treated as advances against future distributions of carry and are market standard provisions included in limited partnership agreements. These provisions are universally disclosed to and understood by investors and are even commonplace outside the alternative investment industry, in many partnerships with service and capital partners.

9. Should advisers to certain fund types have a longer (or shorter) transition period (if the proposed rules are adopted)?

In response to the Commission question, we believe the Commission should not apply, at a minimum, the prohibitions in the Proposed Rules to existing contractual arrangements. To the extent that the Commission decides to move forward in finalizing any of the Proposed Rules, we strongly encourage the Commission to provide for both grandfathering of existing arrangements and a transition period of 24 months for funds formed after the effective date of the rule, which would better reflect the time that would be required to implement such sweeping changes.

As discussed in the April Comment Letter, with respect to grandfathering of existing relationships and agreements, we note that many of the proposed changes likely will require advisers to renegotiate agreements with investors, a process that will require investor cooperation and, as such, is not entirely in the adviser's control. This raises both process concerns (*i.e.*, the cost in both time and dollars that is potentially required to implement these changes is staggering) and substantive concerns (*i.e.*, these contractual terms were negotiated between sophisticated parties that now have significant reliance and other interests that are being upset). We respectfully submit that none of these concerns are given adequate consideration in the

Proposal, and that the Proposal significantly underestimates the costs of the proposals on existing private funds.

Renegotiating agreements with investors does not merely entail changing a few words in one or two agreements per fund—*i.e.*, the relevant provisions (especially the indemnification prohibition, but other provisions in the Proposed Rules as well) appear in basically every document within a particular fund complex. For any single fund that can run to dozens of agreements, and such total would need to be multiplied by however many funds an individual adviser has. Industry-wide, this would require advisers and investors to negotiate (and bear the costs of) amendments to hundreds of thousands of agreements, if not substantially more. Furthermore, some of the Proposed Rules potentially implicate contracts with third parties (*e.g.*, service providers offering administration, accounting, valuation and/or other services). Each of these contracts would need to be analyzed, negotiated, and then implemented. Furthermore, it is not simply a matter of changing the words directly affected by the Proposed Rules. Advisers and their investors will need to consider carefully how changing the aspects of their arrangement that are directly affected by the Proposed Rules will affect other aspects of the arrangement—*i.e.*, the terms governing a private must be considered as an overall package, with changes in one area potentially necessitating changes in one or more other areas. Although some of the changes can be made unilaterally, we anticipate that most will require investor notice and/or consent, which may or may not be given. At a minimum, then, amending existing arrangements would be an expensive undertaking. In reality, it is very likely also to create significant uncertainty, potentially for a prolonged period of time, and in certain cases material misalignment of incentives and other material adverse consequences for investors.

Moreover, in some cases, rather than renegotiating the terms of their agreements with advisers, investors will choose or be forced to redeem their investments. These redemptions have the potential to harm those investors as well as investors remaining in the relevant fund, and—if sizable enough—could cause funds to dissolve and their advisers to go out of business. For example, if advisers are prohibited from passing certain fees and expenses on to investors, they will need to raise their management fees, as we suggest may occur above. However, this will require investor consent, and advisers will need to give investors a right to redeem. Faced with enough redemption requests, funds will no longer be able to operate—potentially causing harm to the remaining investors and leading to market liquidations, which will create market instability.

Accordingly, in light of the cost and the practical challenges associated with getting investor consent to renegotiate existing agreements, and the potential harm to investors and advisers in those cases where renegotiation is not possible or desirable, we believe the Commission should apply any final rules only on a going forward basis and not apply any final rules to existing agreements or arrangements.

## III. The Commission Should Conduct Aggregate Cost-Benefit Analysis

The Commission solicits general comment on whether it has accurately characterized the costs and benefits of the Proposed Rules.[40]As discussed in the April Comment Letter, a robust evidentiary record, including a cost-benefit analysis, is an integral part of the rulemaking process.[41]

Since the end of last year, the Commission has proposed an unprecedented number of significant rulemakings, which would reshape the make-up of the securities markets and their participants, including a number of rules imposing new, substantive requirements on private fund advisers. As such, we think it is imperative for the Commission to conduct a more comprehensive cost-benefit analysis that includes an aggregate review of the impact of the costs from other rulemakings on investment advisers.[42] It is our view that in aggregate the myriad of legal, regulatory, compliance, and operational costs from the Commission's rulemakings that impact investment advisers will be significant. We are greatly concerned that the combined costs will harm investors by increasing costs, making private funds less accessible, and decreasing competition by making it cost-prohibitive for many private fund advisers and new advisers to stay in business or start a business.

As a general economic principle, as the cost and burden of regulation increases, the number of registrants or market participants subject to such requirements will decrease. Accordingly, we think it is important that the Commission include in its cost-benefit analysis a discussion of the estimated decrease in the number of registered investment advisers and private funds and the related impact on institutional investors and their beneficiaries, and the impact on the U.S. capital markets with respect to capital raising.

In the following, we briefly discuss (1) the aggregate costs of the SEC's recently proposed rulemakings affecting private funds advisers and (2) the effect of the aggregate costs of the proposed rules will have on smaller and newly-formed advisers and the industry as a whole.

### A. Aggregate Costs of the Commission's Recently Proposed Rulemakings

As noted above, the Commission has provided a cost-benefit analysis of each of its proposed rulemakings in isolation from other proposals—*i.e.*, without considering the aggregate costs on advisers if all of these proposals were adopted as proposed (or even multiple proposals were to be adopted). Previously we submitted an economic impact analysis of the Proposed

[40] Proposal at 16,690.

[41] *See* April Comment Letter at 10-11. As the Commission is aware, courts have held that rulemaking that is "unsupported by substantial evidence" constitutes unlawful agency action. *See Susquehana Int'l Grp., LLP v. SEC, 866 F. 3d 442 (D.C. Cir. 2017).*

[42] Appendix A contains a list of recent rule proposals affecting private fund advisers, along with key comments contained in MFA comment letters on the cost-benefit analysis in each of the proposals, nearly all of which in our view fail to satisfy the Commission's obligation to conduct a robust cost-benefit analysis.

Rules to illustrate our concerns with their effect on the vitality of the financial markets,[43] and we are planning on doing the same for the Commission's proposed rule to define the terms "dealer" and "government securities dealer" in the Securities Exchange Act of 1934 ("**Exchange Act**"). To assist the Commission with its cost-benefit analysis, we are providing a brief overview of the recent proposed rulemakings that affect private fund advisers, along with some concerns regarding the impact the aggregate costs of these proposals will have on advisers.[44] In addition, we include in this letter Appendix A, which references some of the additional costs from the Commission's proposed rulemakings that will impact advisers of private funds, as well as points out where we believe the Commission has underestimated costs.

*New Reporting Regimes*

Since the end of last year, the Commission has proposed new reporting obligations that will directly affect private fund advisers with respect to securities loans,[45] short position and short activity,[46] beneficial ownership,[47] large security-based swap ("**SBS**") positions,[48] and

---

[43] Attached to our April Comment Letter, we also submitted for the Commission's consideration a report from Professor Craig M. Lewis ("**Lewis Report**"), the Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management and a former SEC Chief Economist and Director of the Division of Economic and Risk Analysis. The Lewis Report focused on the economic analysis and discussion of efficiency, competition, and capital formation contained in the Proposal. The Lewis Report identified fundamental flaws in the Commission's assessment of the Proposed Rules on these topics. Further, the Lewis Report clearly demonstrated that the Proposed Rules would have an overall negative impact on private fund investors, contrary to the Commission's stated objectives. It also clearly demonstrated that the Proposed Rules will have wide ranging and distortive effects on the efficient allocation of capital and the competitiveness of the asset management industry.

[44] The Commission has recently proposed three other proposals that will affect private fund advisers that we will not address here because we have not yet submitted comment letters: Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, Release Nos. 33-11068; 34-94985; IA-6034; IC-34594; File No. S7-17-22 (May 25, 2022) ("**ESG Proposal for Advisers**"); The Enhancement and Standardization of Climate-Related Disclosures for Investors, Release Nos. 33-11061; 34-94867; File No. S7-10-22 (May 9, 2022); and Special Purpose Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29,458 (May 13, 2022).

[45] Reporting of Securities Loans, 86 Fed. Reg. 69,802 (Dec. 8, 2021); Reopening of Comment Period for Reporting of Securities Loans, 87 Fed. Reg. 11,659 (Mar. 2, 2022).

[46] Short Position and Short Activity Reporting by Institutional Investment Managers; Notice of Proposed Amendments to the National Market System Plan Governing the Consolidated Audit Trail for Purposes of Short Sale-related Data Collection, 87 Fed. Reg. 14,950 (Mar. 16, 2022).

[47] Modernization of Beneficial Ownership Reporting, 87 Fed. Reg. 13846 (Mar. 10, 2022).

[48] Prohibition Against Fraud, Manipulation, or Deception in Connection With Security-Based Swaps; Prohibition Against Undue Influence Over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions, 87 Fed. Reg. 6,652 (Feb. 4, 2022).

disclosures on Form PF.[49] These reporting obligations are largely in addition to existing reporting obligations of private fund advisers, not in place of them. In other words, rather than making existing reporting frameworks more efficient and useful to the Commission, the Commission instead has generally chosen to impose entirely new reporting regimes on market participants.[50]

If all of these rules are adopted as proposed, private fund advisers would need to create the following new compliance infrastructure or systems to address the new requirements:

- Securities loans—The proposed rule would require an entirely new infrastructure for loan data reporting and dissemination.
- Short position and short activity reporting—The proposed rule and form would create an entirely new, unduly complicated, and very costly framework for managers, including tracking daily activity in positions over the relevant threshold.
- Beneficial ownership—The proposed new reporting timelines for 13G filers will dramatically increase costs and pose significant logistical challenges, and by increasing overhead costs and expanding an already complex regulatory regime, the Commission's accelerated timeline will render it particularly difficult for smaller managers, who cannot readily bear the costs and administrative burden of monthly filings.
- Large SBS position reporting—It will be necessary for market participants to implement and maintain extensive new compliance systems, including the infrastructure required to monitor transactions continuously, identify SBS positions subject to the reporting requirement and update reports as necessary (which, for many market participants, will be on a daily or near-daily basis), at substantial initial and ongoing cost and burden.
- Form PF—Advisers will need to retool private fund administrative systems to collect new data in new ways, including determining daily final net asset value of portfolios consisting of level 3 securities as well as tracking margin and collateral over rolling 10-day periods.

Individually, we consider the Commission's cost-benefit analysis of these reporting regimes as generally inadequate, and we believe the Commission grossly underestimates the costs of these rules, particularly the cost of developing infrastructure to comply with the new reporting regimes.

---

[49] Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, 87 Fed. Reg. 9,106 (Feb. 17, 2022).

[50] *See* Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC (Mar. 21, 2022), at 2, available at: https://www.sec.gov/comments/s7-01-22/s70122-20120683-272854.pdf.

*Substantive Obligations Targeted Directly at Private Fund Advisers*

Since the beginning of the year, the Commission has proposed new substantive obligations on private fund advisers in the Proposed Rules, in the cybersecurity risk management proposal,[51] and in amending Form PF (which we considered above).[52]

- Private fund adviser proposal—The Proposed Rules would greatly expand regulatory compliance obligations for all investment advisers to private funds, including costly new reporting obligations,[53] and, if the final rules do not include a grandfathering provision for existing arrangements, will impose significant restructuring costs on the private fund industry.[54]

- Cybersecurity risk management—The proposal contains more prescriptive requirements compared to existing SEC cybersecurity guidance and rules related to safeguarding information such as Regulation S-P and would require most registered advisers to implement enhancements to their cybersecurity programs, as well as imposes additional reporting and disclosure obligations on private fund advisers.

- Form PF—See above.

These rulemakings will increase the regulatory, compliance, and legal costs of operating an investment adviser dramatically.

*Additional Rulemakings*

Since the end of last year, the Commission also has proposed three other rulemakings that could dramatically impact private fund advisers if they are adopted in their current form: the proposed amendments to Exchange Act Rule 3b-16 (the definition of exchange) and Regulation

[51] Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, 87 Fed. Reg. 16,590 (Mar. 23, 2022).

[52] While we are still formulating our views, it appears to us that the ESG Proposal for Advisers will also impose very significant costs on private fund advisers.

[53] *See* TIAA Letter at 11 ("As is the case with certain other proposed disclosure requirements we have discussed above, we are concerned that the SEC's proposed quarterly statement requirement would impose significant costs on private fund advisers (and ultimately their investors), without producing any material benefit for investors)").

[54] *See* Section II.D.9, *supra*.

ATS[55] and the proposed definitions of "dealer" and "government securities dealer" in the Exchange Act.[56]

- Regulation ATS and Definition of "Exchange"—Unless the Commission clearly indicates that it does not intend order/execution management systems, single firm trading interest communication systems, and order routing systems to be deemed "exchanges" within the scope of the proposed definition, there will be significant costs to advisers to comply with applicable requirements.

- Dealer Proposal—Registering and operating as a dealer would impose significant costs on advisers and the funds they manage. In particular, it is unworkable to subject those who invest in the Treasury market as customers to an extremely burdensome regulatory framework designed specifically for dealer firms, meaning that these customers may be compelled to materially withdraw from the market.

We expect the Commission to exclude order/execution management systems, single firm trading interest communication systems, and order routing systems from the definition of "exchange." However, unless the Commission includes an exception for advisers and private funds from the proposed definition of "dealer" and "government security dealer," as we recommended in our comment letter on the dealer proposal, there will be significant costs to advisers or private funds, depending on which registers with the Commission as a dealer.

### B. Effect on Smaller and Newly-Formed Advisers and the Industry as a Whole

Notwithstanding the impact on existing advisers and the ability of many small and mid-size advisers to manage costs, the aggregate cost of the Commission's recently proposed rulemakings will be almost insurmountable for smaller and newly-formed advisers, including women and minority-owned advisers (who are already under-represented in the industry). This will create barriers to entry for new advisers, which will further contribute to industry consolidation, with the result being decreased investment competition and investor choice.[57]

The alternative investment industry thrives on new entrants, entrepreneurship, and competition. Imposing significant costs and eliminating long-standing industry practices that enable smaller and newer firms to incentivize early investors and tailor fund terms appropriately

---

[55] Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"; Regulation ATS for ATSs That Trade U.S. Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade U.S. Treasury Securities and Agency Securities, 87 Fed. Reg. 15,496 (Mar. 18, 2022).

[56] Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23,054 (Apr. 18, 2022).

[57] *See, e.g.,* Letter from Marcus Glover, General & Managing Partner, Lockstep Ventures, to Vanessa Countryman, Secretary, SEC (Apr. 25, 2022), at 1-2, available at: https://www.sec.gov/comments/s7-03-22/s70322-20126650-287354.pdf ("As a small firm, we believe the Proposal would unnecessarily burden our firm and other emerging private fund managers who do not have the in-house capacity to review and respond to each of the proposed rules. Further, the Proposal would hurt investors if preferential treatment rules were eliminated, thereby destroying our ability to keep or attract certain investors.").

will make it harder to launch new firms and harder for new managers to succeed, thereby harming investors' ability to generate returns on behalf of their ultimate beneficiaries.[58]

It stands to reason that the aggregate burden of all the Commission's recently proposed rules will have a similar effect on private fund advisers, especially smaller and newly-formed advisers who often have tighter margins and fewer resources to apply to compliance. Such advisers may well decide to exit the market or be deterred from entering the market in the first place, resulting in fewer, larger managers with more market power and less investor choice, diversity, and competition within the industry—the exact opposite of one of the primary purported goals of the rulemakings.

Accordingly, as the Commission weighs the costs and benefits of the Proposed Rules—and their effect on competition, efficiency, and capital formation—it should address the fact that the likely result of all the Commission's recently proposed rules will be consolidation in the private fund industry, where only large firms can bear the costs of applicable rules. Instead of implementing rules that will cause these harmful effects, the Commission should carefully reconsider how it can better address investor protection concerns for which it has presented sufficient evidence in ways that avoid unnecessary compliance costs for all advisers, especially smaller and newly-formed advisers.

---

[58] In this regard, it is instructive to consider the decline in the number of broker-dealers and futures commission merchants ("**FCMs**") in recent years, as well as banking industry consolidation. The number of broker-dealers has declined significantly over the last decade. In March 2017, there were 3,989 SEC-registered broker-dealers compared to 5,892 in March 2007, which is more than a thirty percent drop. Similarly, there were 171 FCMs in March 2007 but only 64 in March of this year, a more than sixty percent decline, and, between 1984 and 2020, the number of banks decreased by 70%. *See* Hester Peirce, "Dwindling Numbers in the Financial Industry," Brookings Center on Regulation and Markets (May 15, 2017), available at: https://www.brookings.edu/research/dwindling-numbers-in-the-financial-industry/; William R. Emmons, Federal Reserve Bank of St. Louis, "Slow, Steady Decline in the Number of U.S. Banks Continues" (Dec. 9, 2021), available at: https://www.stlouisfed.org/on-the-economy/2021/december/steady-decline-number-us-banks.

Some have pointed to increased regulation as an important factor in the dwindling number of FCMs, broker-dealers, and banks, noting that regulation has increased quite substantially over time. *See, e.g.,* Peirce, "Dwindling Numbers in the Financial Industry," *supra*; Roisin McCord, Edward Simpson Prescott, and Tim Sablik, Federal Reserve Bank of Richmond, Economic Brief 15-03, "Explaining the Decline in the Number of Banks since the Great Recession" (Mar. 2015), at 4, available at: https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-03.pdf.

* * *

## IV. Conclusion

MFA appreciates the opportunity to provide additional comments to the Commission on the Proposed Rules. We welcome the opportunity to discuss our views with you in greater detail. Please do not hesitate to contact Matthew Daigler, Vice President & Senior Counsel, or the undersigned, at (202) 730-2600, with any questions that you, your respective staffs, or the Commission staff might have regarding this letter.

Very truly yours,

/S/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Allison Herren Lee, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner
Mr. William Birdthistle, Director, Division of Investment Management

**APPENDIX A**

**MFA Comments on Cost-Benefit Analysis in Recent Rule Proposals Affecting Private Fund Advisers**

| No. | Title of Rule Proposal | Issued | MFA Comments on Cost-Benefit Analysis |
|---|---|---|---|
| 1. | Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies | 5/25/22 | MFA Comment Letter: *[Forthcoming]* |
| 2. | Reopening of Comment Period for Reporting of Securities Loans | 4/1/22 | "Finally, we are of the view that the Proposed Rule will saddle market participants with the costs of creating and maintaining an entirely new infrastructure for loan data reporting and dissemination. Those costs will greatly exceed any benefits that may come from the Proposed Rule and will certainly be borne by investors including, mutual funds, pension funds, and university endowments, which receive income from lending out their securities holdings." (Page 3)<br><br>"We urge the Commission to conduct a cost-benefit analysis of the impact of the Proposed Rule on trading strategies and the detrimental impact on investors, the markets, and capital formation." (Page 8)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-18-21/s71821-20122184-278025.pdf & https://www.sec.gov/comments/s7-18-21/s71821-20111683-265021.pdf |
| 3. | Special Purpose Acquisition Companies, Shell Companies, and Projections | 3/30/22 | MFA Comment Letter: *[Forthcoming]* |

| No. | Title of Rule Proposal | Issued | MFA Comments on Cost-Benefit Analysis |
|---|---|---|---|
| 4. | Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer | 3/28/22 | "The rule will reduce liquidity, harm price discovery, and increase the cost of capital for companies and the U.S. government." (Page 2)<br><br>"Subjecting private funds and their advisers to dealer registration would expose funds and their investors to material costs and risks that the Proposal does not identify or address." (Page 2)<br><br>"Treating private funds and their advisers as dealers would . . . expose private funds and their investors to significant new risks and costs. The Proposal fails to identify, much less consider or justify, many of these risks and costs. . . ." (Page 3)<br><br>"As a result, the Proposal's economic analysis incorrectly assesses both the scope and number of affected firms and the direct and indirect costs of subjecting those firms to dealer registration, thus falling short of the Commission's obligations under the APA and Sections 3(f) and 23(a)(2) of the Exchange Act." (Page 4)<br><br>"The Commission has not adequately considered the significant costs to market participants, securities markets, and the broader economy that will almost certainly result from the Proposal, as it is required to do under the APA and the Exchange Act." (Page 18)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-12-22/s71222-20129911-296085.pdf |
| 5. | The Enhancement and Standardization of Climate-Related Disclosures for Investors | 3/21/22 | MFA Comment Letter: *[Forthcoming]* |

| No. | Title of Rule Proposal | Issued | MFA Comments on Cost-Benefit Analysis |
|---|---|---|---|
| 6. | Short Position and Short Activity Reporting by Institutional Investment Managers; Notice of Proposed Amendments to the National Market System Plan Governing the Consolidated Audit Trail for Purposes of Short Sale-related Data Collection | 2/25/22 | "In addition, the proposed rule and form would create an entirely new, unduly complicated, and very costly framework for managers when all of the information needed to satisfy the public disclosure mandate of Section 929X(a), and much of the additional information sought by the SEC, is already readily available for publication or, as applicable, use by regulators." (Page 2)<br><br>"Furthermore, as the Commission conducts its cost-benefit analysis and evaluates the burden on managers, we urge it to consider in aggregate the legal, regulatory, compliance, and operational costs to managers of all of the SEC's proposed rulemakings in their entirety. We are strongly concerned that the combined costs will be insurmountable for small and newly-formed advisers, and lead to industry consolidation, thereby decreasing investment competition and investor choice." (Page 2)<br><br>"Second, we believe the cost and impact of the reporting and disclosure of short position data as proposed is not adequately weighed against the benefits thereof." (Page 3)<br><br>"Much of the incremental data that would be obtained under the Proposal could be obtained more efficiently leveraging the existing infrastructure. Obtaining such data directly from managers in the format proposed by Form SHO would be of limited additional value given the breadth and depth of market information already available. In addition, any benefit would be outweighed by the significant risks of the proposed reporting infrastructure and its attendant costs to investment managers (and thus to their clients and investors)." (Page 5)<br><br>"While we appreciate the SEC has limited resources, we do not believe the SEC's administrative convenience for its sporadic need to reconstruct |

| No. | Title of Rule Proposal | Issued | MFA Comments on Cost-Benefit Analysis |
|---|---|---|---|
| | | | market events justifies the significant ongoing costs and consequences of the Proposal, many of which are detailed below.” (Page 7)<br><br>“In addition, there are numerous other material costs, risks, and potential flaws in the Proposal, many of which are cited but not fully weighed by the SEC in the Release. For example, the SEC acknowledges the substantial compliance costs associated with filing Form SHO (compounded by the costs associated with accommodating the additional order marks, pursuant to Proposed Rule 205 and the SEC’s proposal to Amend CAT), however, the SEC fails to acknowledge and capture the costs and expenses that will be forced upon a wide range of managers that will need to buy or develop systems to monitor for compliance with the SEC’s proposed thresholds.” (Page 10)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-08-22/s70822-20126815-287523.pdf |
| 7. | Modernization of Beneficial Ownership Reporting | 2/10/22 | “The significant additional disclosure burdens that the Commission’s proposed changes would place on investors will impose impracticable costs, raise barriers to entry, and ultimately inhibit capital raising.” (Page 2)<br><br>“The costs of the Commission’s proposed changes—to the investment community and the market at large—come with little discernible benefit.” (Page 2)<br><br>“If implemented, the Commission’s proposed changes to its Schedule 13G amendment timelines will cause the costs and burdens on Schedule 13G filers to skyrocket—especially for algorithmic traders with continually fluctuating positions who would need to monitor positions on a daily basis—and would flood the market with near-constant filings |

| No. | Title of Rule Proposal | Issued | MFA Comments on Cost-Benefit Analysis |
|---|---|---|---|
| | | | about relatively small changes in the holdings of investors with no control intent.” (Page 5)<br><br>“Respectfully, the Commission’s proposals reflect inadequate consideration of the dramatically increased costs, significant logistical challenges and policy implications of its proposed timelines.” (Page 14)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-06-22/s70622-20123269-279539.pdf |
| 8. | Shortening the Securities Transaction Settlement Cycle | 2/9/22 | *No significant comments on the cost-benefit analysis.*<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-05-22/s70522-20123267-279538.pdf |
| 9. | Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies | 2/9/22 | “Moreover, the costs imposed by certain aspects of the Proposed Rules will create significant barriers to entry for new advisers, thereby limiting investor choices and potentially negatively impacting other efforts by the Commission and President Biden’s administration to promote greater diversity within the asset management industry.” (Page 2)<br><br>“In addition, the specialized nature of cybersecurity expertise and limited availability of existing resources in the cybersecurity industry will create challenges for many advisers to obtain services and likely will impose significant costs on advisers.” (Page 9)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-04-22/s70422-20123280-279547.pdf |
| 10. | Private Fund Advisers; Documentation of Registered | 2/9/22 | “The Proposed Rules will have numerous and significant adverse consequences on investors, with limited offsetting benefits, which the |

| No. | Title of Rule Proposal | Issued | MFA Comments on Cost-Benefit Analysis |
|---|---|---|---|
| | Investment Adviser Compliance Reviews | | Commission failed to adequately consider in conducting its cost-benefit analysis." (Page 3)<br><br>"The Proposed Rules are likely to have disproportionate adverse effects on, and to create significant barriers to entry for, smaller and newly-formed investment advisers because such advisers have less ability to increase their management or similar fees, are likely to be unable to bear the additional costs that the Proposed Rules would impose, and require significant flexibility regarding the terms that they negotiate with seed, anchor, and other investors." (Page 3)<br><br>"It is clear that the Commission has not conducted a robust cost-benefit analysis that demonstrates (i) the need for the Proposed Rules; (ii) a thorough assessment of both the costs and the benefits of the Proposed Rules and their effect on investors and capital formation; or (iii) that less costly alternatives are unavailable." (Page 11)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-03-22/s70322-20126631-287270.pdf |
| 11. | Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"; Regulation ATS for ATSs That Trade U.S. Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade U.S. Treasury Securities and Agency Securities | 1/26/22 | "Unless the Commission clearly indicates that it does not intend such systems [i.e., order/execution management systems, single firm trading interest communication systems, and order routing systems] to be deemed 'exchanges' within the scope of the proposed definition, then MFA believes the Commission should perform a far more extensive and rigorous analysis of the attendant consequences and costs of such a policy decision than the Proposal currently presents." (Page 9)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-02-22/s70222-20123993-280134.pdf |

| No. | Title of Rule Proposal | Issued | MFA Comments on Cost-Benefit Analysis |
| --- | --- | --- | --- |
| 12. | Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers | 1/26/22 | "Imposing these costs on Large Hedge Fund Advisers also would likely raise the barrier to entry for new hedge fund advisers. This could eliminate new entrants and decrease competition in the marketplace." (Page 9, n.12)<br><br>"The discussion of the costs assumes that funds could utilize existing capabilities for preparing Form PF, which ignores the dramatically different nature of the information that is currently required to be reported." (p. 25)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-01-22/s70122-20120683-272854.pdf |
| 13. | Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers | 12/15/22 | "Our comments below reflect our concern that the Commission's proposed rule could result in costly unintended consequences to the functioning and liquidity of the markets to which it would apply." (Page 1)<br><br>"[Re-proposed Rule 9j-1] will operate not only to the detriment of security-based swap market participants, but also issuers, who will face increased costs of debt and reduced availability of capital, particularly in instances where the issuer is in financial distress." (Page 2)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-32-10/s73210-20120732-272888.pdf |
| 14. | Position Reporting of Large Security-Based Swap Positions | 12/15/22 | "We also have serious concerns that the Commission has not adequately considered the true costs of proposed Rule 10B-1—particularly with respect to the public disclosure requirements—as required under the Administrative Procedure Act (the 'APA')." (Page 2) |

| No. | Title of Rule Proposal | Issued | MFA Comments on Cost-Benefit Analysis |
|---|---|---|---|
| | | | "Indeed, we believe that, as written, proposed Rule 10B-1 will likely result in a significant number of SBS market participants exiting the market altogether, or limiting their use of SBSs, which will reduce liquidity and make it more costly, or impossible, for market participants to enter into essential hedging transactions. In turn, this will limit the availability, and increase the cost, of capital for issuers." (Page 2)<br><br>"In addition, it will be necessary for market participants to implement and maintain extensive new compliance systems, including the infrastructure required to monitor transactions continuously, identify positions subject to the reporting requirement and update reports as necessary (which, for many market participants, will be on a daily or near-daily basis), at substantial initial and ongoing cost and burden." (Page 2)<br><br>"The Commission has not adequately considered the costs and adverse consequences of public disclosure of SBS positions on SBS and underlying securities markets, and the participants in these markets." (Page 3)<br><br>MFA Comment Letter: https://www.sec.gov/comments/s7-32-10/s73210-20120700-272867.pdf |