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

November 23, 2022

Via Electronic Submission

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

Re: Proposed Rule on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (RIN: 3235-AN07; Release No. IA-5955; File No. S7-03-22)

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] submits these comments to the Securities and Exchange Commission ("**Commission**" or "**SEC**") in response to the Commission's proposed rules regarding private fund advisers ("**Proposed Rules**").[2] These comments supplement our comment letters dated April 25, 2022, and June 13, 2022, regarding the Proposed Rules ("**Comment Letters**"),[3] and are in furtherance of meetings we and our members have had with SEC Commissioners and staff.

[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] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16886 (Mar. 24, 2022) ("**Proposal**"), available at: https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf; 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," 87 Fed. Reg. 29,059 (May 12, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-05-12/pdf/2022-10195.pdf; Resubmission of Comments and Reopening of Comment Periods for Several Rulemaking Releases Due to a Technological Error in Receiving Certain Comments, 87 Fed. Reg. 63,016 (Oct. 18, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-10-18/pdf/2022-22295.pdf.

[3] 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:

Specifically, in the Annex to this letter, we offer suggested changes to the Proposed Rules that are intended to offer the Commission alternative approaches to address its policy concerns, as we understand them, while mitigating, at least in part, some of the negative, unintended consequences of certain of the more problematic aspects of the Proposed Rules. Although we have not offered suggested changes to every Proposed Rule discussed in our Comment Letters, the Commission should not read this letter as expressing support for aspects of the Proposed Rules not addressed in the Annex to this letter (*e.g.*, we continue to oppose the after-tax clawback and the quarterly statement requirements in their current form). In addition, our suggested changes do not include provisions that we believe must be added to the Proposed Rules if the Commission were to proceed, as already described in the record (*e.g.*, a grandfathering provision and a longer transition period).

Finally, MFA continues to be particularly concerned that the Commission lacks statutory authority to promulgate many of the Proposed Rules and 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.[4] As such, none of our comments should be construed to suggest that we or our members believe the Commission possesses such statutory authority or has conducted a proper economic analysis, even if the Proposal is modified as suggested.

We continue to believe that the best course of action would be for the Commission to withdraw the Proposed Rules in their entirety and, if the Commission desires to better understand the questions and potential concerns it raises in the release accompanying the Proposal, to conduct an in-depth research effort before proceeding, as it has done when considering significant rules in the past.

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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; Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC (June 13, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20131144-301341.pdf.

[4] In addition, we continue to consider how the Supreme Court's decision in *West Virginia v. Environmental Protection Agency (EPA)*, 142 S. Ct. 2587 (2022), impacts the Proposed Rules and, in particular, whether the Commission has the authority to fundamentally alter the longstanding, widely used business arrangements of private funds and their advisers.

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. Caroline A. Crenshaw, SEC Commissioner
The Hon. Mark T. Uyeda, SEC Commissioner
The Hon. Jaime Lizárraga, SEC Commissioner
Mr. William Birdthistle, Director, Division of Investment Management

Annex

Subject to the discussion and qualifications in the letter that accompanies this Annex, MFA provides the following suggested textual changes to the Proposed Rules. These suggested changes are intended to offer the Commission alternative approaches to address its policy concerns, as we understand them, while mitigating, at least in part, some of the negative, unintended consequences of some of the more problematic aspects of the Proposed Rules. The notes accompanying these suggested changes are intended to highlight certain reasons for the changes but should be read in conjunction with our Comment Letters, which provide a fuller explanation of our concerns with the Proposed Rules.

7. Section 275.211(h)(2)-1 is added to read as follows:

§ 275.211(h)(2)-1 Private fund adviser prohibited activities.

(a) An investment adviser to a private fund may not, directly or indirectly, do the following with respect to the private fund, or any investor in that private fund:

(1) […]

(2) Charge the private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, unless the adviser's or its related persons' authority to charge such fees or expenses has been disclosed in advance to investors in such private fund;

(3) Charge the private fund for any regulatory or compliance fees or expenses of the adviser or its related persons, unless the adviser's or its related persons' authority to charge such fees or expenses has been disclosed in advance to investors in such private fund;

Notes:

- ***In proposing this sweeping prohibition, the Commission does not cite to any legal authority that supports prohibiting advisers from charging certain fees and expenses to a client when this economic arrangement has been disclosed to investors.***
- ***In discussions we have had with SEC Commissioners and staff, it appears that one of the principal justifications for the prohibition is a desire to prevent advisers from passing through to investors fees and expenses related to wrongdoing, such as in an enforcement matter the Commission successfully litigates to final judgment. However, the Commission already has the authority to address this specific concern.***
- ***Moreover, rather than narrowly tailoring the rule to this specific concern, the Proposal instead confusingly penalizes advisers for investing in regulatory and compliance functions to comply with applicable rules and regulations and for pursuing investment***

strategies with significant regulatory components (e.g., such as reinsurance or direct lending).

- ***As detailed in our Comment Letters, the Commission fails to articulate why regulatory, compliance, examination, and investigation-related expenses are singled-out, or how this type of disclosed economic arrangement creates a purported conflict of interest for the adviser. As evidence of the lack of any purported conflict of interest, we note that research has been submitted in the record showing pass-through funds are increasingly sought-after by investors and deliver superior net returns to investors.***

- ***We further note that if this prohibition were to be implemented, the likely effect would be for advisers to effectively charge these same expenses to investors by raising their management fees, which are inherently less transparent.***

(4) […]

(5) Seek 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,~~ fraud, gross negligence, or recklessness in providing services to the private fund;

Notes:

- ***This Proposed Rule prescribes a standard of care that interferes with rights under state and non-U.S. law and that is unacceptable, both in its extreme overbreadth and its potentially vague application to real world events.***
- ***In addition, as many commenters (including investors) have pointed out, a simple negligence standard of care will have a material adverse effect on advisers' ability to perform the services and to deliver the returns that private fund investors expect, significantly affecting the industry and the investors in those funds, without an adequate basis justifying such action. The Proposal also fails to address why private fund advisers should be subjected to the comparatively higher simple negligence standard when advisers to registered investment companies are permitted to operate under a gross negligence standard.[5] The Proposal provides no justification for this disconnect, which is especially troubling given the sophistication requirements for investors in private funds and the greater relative complexity of the investment strategies offered by private fund advisers.***
- ***We have added "fraud" to the list of enumerated types of conduct, in lieu of "bad faith," as we believe it is more consistent with what the Commission intends than the current language.***
- ***Accordingly, the suggested changes to the Proposed Rule are designed to preserve the Proposal's intent while addressing the myriad unintended and adverse consequences identified in our Comment Letters.***

[5] Section 17(i) of the Investment Company Act of 1940 prohibits 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."

(6) Charge or allocate 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*, unless such investment adviser determines in good faith that doing so would be fair and equitable; and

Notes:

- ***As illustrated by the examples provided by MFA in our Comment Letters, this Proposed Rule will harm investors by mandating a prescriptive allocation methodology that would yield unfair and inequitable results and discourage advisers from incurring expenses that are beneficial to investors.***

- ***Among other things, this prohibition 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.***

- ***Furthermore, 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 our Comment Letters, this prohibition also will make it more difficult for such advisers to attract the seed capital necessary to start and maintain their businesses.***

(7) Borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client, other than (a) advances or other amounts received by an investment adviser or its *related persons* out of such person's actual or anticipated share of the assets of such private fund client or (b) in connection with activities of an investment adviser or its *related persons* engaged in for the benefit of such private fund client.

Notes:

- ***This prohibition would arguably prohibit advisers from taking advances from their share of the fund's assets (including accrued performance fees) for legitimate purposes (e.g., to pay tax obligations or to fund employee compensation, as when a payroll provider requires pre-funding). However, such advances benefit investors by preventing premature asset sales and aligning interests among investors and their advisers. We do not believe the Proposed Rule should prohibit them.***

- ***In addition, there may be other situations where the contractual arrangement between the adviser and the private fund client permits borrowing of amounts that are appropriately incurred in furtherance of the adviser's activities on behalf of the private fund. Because of the breadth of this Proposed Rule, however, it is possible that such transactions could be characterized as prohibited extensions of credit, which would needlessly harm the investors in such private fund.***

* * *

9. Section 275.211(h)(2)-3 is added to read as follows:

§ 275.211(h)(2)-3 Preferential treatment.

Preliminary Considerations:

- ***In addition to the proposed changes below, we suggest that the Commission reframe the "preferential treatment" rules not as prohibitions but as a requirement for advisers to have policies and procedures reasonably designed to ensure that any liquidity or portfolio holdings information provided to only certain investors comply with the standards articulated below, as revised.***

- ***We further do not believe that the Proposed Rule should extend to a "substantially similar pool of assets." As currently drafted the definition of this term is overbroad and potentially includes various entities in addition to the entities the Commission apparently intends to capture. However, if the Commission is unwilling to eliminate this concept from the Proposed Rule in its entirely, we have suggested revisions to the definition of "substantially similar pool of assets" below to address these concerns.***

- ***We also have included definitions of the terms "side letter" (applicable to both paragraphs (a) and (b) below) and "preferential treatment" (applicable to paragraph (b) below).***

(a) An investment adviser to a private fund may not, directly or indirectly, enter into a *side letter* that would do the following with respect to the private fund, or any investor in that private fund:

(1) Grant an investor in the private fund or in a ~~substantially similar~~ *parallel pool of assets* the ability to redeem its interest on more favorable terms than other investors in the private fund or *parallel pool of assets*, unless ~~that~~ the adviser determines in good faith, at the time such *side letter* is entered into and based on the facts and circumstances known to the adviser at such time, that (a) it is more likely than not that any such ability will not ~~reasonably expects to~~ have a material, negative effect on other investors in that private fund or in a ~~*substantially similar*~~ *parallel pool of assets* or (b) such ability is being granted to address legal, regulatory, tax, and/or other similar matters, and/or other legitimate needs of the investor, in each case as communicated to the adviser by such investor, upon which communication the adviser may conclusively rely, or as otherwise determined in good faith by the adviser; or

(2) Provide information regarding the portfolio holdings or exposures of the private fund, or of a ~~substantially similar~~ *parallel pool of assets*, to any investor in such private fund or *parallel pool of assets* that is not made generally available to other investors in the private fund or *parallel pool of assets*, unless ~~if~~ the adviser determines in good faith, at the time such *side letter* is entered into and based on the facts and

circumstances known to the adviser at such time, that (a) it is more likely than not that any such information will not ~~reasonably expects that providing the information would~~ have a material, negative effect on other investors in that private fund or in a ~~substantially similar~~*parallel pool of assets* or (b) such information is being provided in connection with legal, regulatory, tax, and/or other similar matters, and/or other legitimate needs of the investor, in each case as communicated to the adviser by such investor, upon which communication the adviser may conclusively rely, or as otherwise determined in good faith by the adviser.

Notes:

- ***The proposed prohibition on "preferential treatment" regarding liquidity and information are clearly beyond the scope of the rulemaking authority delegated to the SEC by Congress in Section 211(h), as the Commission fails to demonstrate that providing a sophisticated investor with the contractual terms it seeks in and of itself is the type of "sales practice, conflict of interest, or compensation scheme" that Section 211(h) was intended to address.***

- ***In this regard, it is particularly relevant to note that generally such requests are driven by investors (asset allocators, fund of funds advisers, large institutions, etc.) that require the liquidity rights or information to fulfil their own fiduciary duties to their clients.***

- ***The Commission fails to demonstrate how providing a sophisticated investor with liquidity or information terms that the investor itself seeks is "contrary to the public interest and the protection of investors."***

- ***As a result of the Proposed Rules, advisers would either be prohibited from complying with legitimate investor requests or have to provide reams of information to investors who have not asked for, and do not need, such information. Not only could needlessly distributing information more widely implicate cybersecurity and data confidentiality issues, it would, most importantly, impose regulations that merely complicate relationships between sophisticated parties with plenty of access to legal and financial expertise.***

- ***Furthermore, more technically, we believe that, as currently drafted, the Proposed Rules:***

    - ***Inappropriately extend beyond side letter agreements (e.g., they could be interpreted to apply to different liquidity classes included in a fund's governing documents);***

    - ***Inadvertently exclude any reference to "preferential" withdrawal or information rights and thus can be read as inadvertently overbroad (e.g., a liquidity provision that applies equally to all investors but proves in***

hindsight to be too permissive could arguably violate the rule in its current form);

- ***Include an overly-restrictive threshold for when the Proposed Rules apply (i.e., "reasonably expects to have a material, negative effect" could be interpreted as a mere foreseeability standard, which could essentially eliminate all preferential liquidity and information provisions); and***

- ***May prohibit advisers from accommodating the legitimate legal, regulatory, tax, and other similar legitimate needs of their investors, thereby disadvantaging such investors or preventing them from investing in private funds more generally.***

➢ ***Finally, if the Commission decides to adopt the proposed prohibitions, clarification is necessary to confirm the prohibitions would not apply in circumstances in which an investor elects to receive less liquidity or less information than other investors (e.g., in exchange for other rights or terms that are more consequential to that investor). In such a circumstance, the investor electing to receive less liquidity or less information would not result in material, negative effects on other investors.***

(b) An investment adviser to a private fund may not, directly or indirectly, enter into a *side letter* that would provide any other *preferential treatment* to any investor in the private fund unless the adviser provides written notices as follows:

(1) *Advance written notice for prospective investors in a private fund*. The investment adviser shall provide to each prospective investor in the private fund, prior to the investor's investment in the private fund, a written notice that provides specific information regarding any *preferential treatment* the adviser or its related persons provide to other investors in the same private fund.

(2) *Annual written notice for current investors in a private fund*. The investment adviser shall *distribute* to current investors, on at least an annual basis, a written notice that provides specific information regarding any *preferential treatment* provided by the adviser or its related persons other investors in the same private fund since the last written notice provided in accordance with this section, if any.

Notes

- ***As with the preferential redemption and information provisions, we believe that this Proposed Rule inappropriately extends beyond side letter agreements (e.g., it would arguably require disclosure of general update calls that occur periodically between an adviser and an investor and that are not mandated by a side letter).***
- ***In addition, the Proposed Rule lacks any materiality standard for when a side letter term must be disclosed. This harms investors by needlessly creating material disincentives for advisers to accommodate side letter requests, particularly in open-end funds which are offered continuously and where side letter disclosure would therefore be especially burdensome and expensive. Accordingly, we suggest a definition for the term "preferential treatment" below.***

(c) For purposes of this section, defined terms shall have the meanings set forth in § 275.211(h)(1)-1.

* * *

5. Section 275.211(h)(1)-1 is added to read as follows:

§ 275.211(h)(1)-1 Definitions.

For purposes of §§ 275.206(4)-10, 275.211(h)(1)-2, 275.211(h)(2)-3, 275.211(h)(2)-1, and 275.211(h)(2)-2:

[…]

Preferential treatment means a *side letter* provision that (a) grants materially more favorable treatment to an investor in a private fund relative to other investors in the private fund and (b) if disclosed to other prospective or current investors in such private fund, would have a material effect on their reasonable assessment of whether to invest in such private fund, as determined by the investment adviser to such private fund in good faith, at the time such *side letter* is entered into and based on the facts and circumstances known to the adviser at such time.

Notes:

- ***The suggested definition of "preferential treatment" is intended to limit the scope of the notice provision discussed above to side letters and to provide a materiality standard.***

Side letter means a binding written agreement with respect to a private fund or a *parallel pool of assets* that is entered into between one or more investors in such private fund or *parallel pool of assets*, respectively, on the one hand, and the applicable investment adviser and/or one or more of such investment adviser's related persons, on the other hand, but excluding in each case the governing documents of such private fund or *parallel pool of assets*.

Notes:

- ***In light of the discussion in the Proposal that focuses on side letters or other types of similar arrangements, and not provisions in the governing documents for a private fund, it appears 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. The suggested definition of "side letter" is intended to reflect this.***

~~Substantially similar~~ Parallel pool of assets means a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940, or a company that elects to be regulated as such, or a "fund of one" vehicle that operates as a means for the adviser to provide investment advice to a particular investor and/or its affiliates) with ~~substantially similar~~ identical investment policies, objectives, ~~or~~ and strategies to those of, and that invests *pari passu* with, the *private fund* managed by the investment adviser or its *related persons*.

Notes:

- ***The phrase "substantially similar investment policies, objectives, or strategies" is vague and overly broad and could lead to advisers treating different pooled vehicles as "substantially similar pools" even when the portfolios of the pooled vehicles diverge in material respects.***

- ***For example, advisers currently have the flexibility to offer investors a range of funds whose liquidity terms are well-tailored to different investors' particular investment mandates. In certain cases, the investment strategies and/or opportunities of such funds may overlap to varying degrees, while such funds nevertheless serve as distinct products offering different commercial terms.***

- ***Accordingly, the suggested revision to the definition of "substantially similar pool of assets" is intended to address these concerns.***