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April 25, 2022

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Via Email to rule-comments@sec.gov File Number S7-01-22

Re: Release No. IA-5955, File No. S7-03-22 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

Dear Ms. Countryman:

The Hedge Fund Association ("HFA") respectfully submits these comments in response to the U.S. Securities and Exchange Commission's ("SEC" or "Commission") request for comments regarding its release titled Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (the "Release").[1] The HFA is an international non-profit industry trade group and nonpartisan lobbying organization established to serve the alternative investment industry. We are devoted to advancing transparency, development and trust. Our global presence spans multiple continents and countries. HFA members, past and present, include hedge fund sponsors, financial institutions, funds of hedge funds, family offices, public and private pension funds, endowments and foundations, high net worth individuals, allocators and service providers including prime brokers, accounting firms, administrators, custodians, auditors, lawyers, technologists and third party marketers.

General Statement

As a general matter, the HFA believes that the Commission should withdraw the proposed rules and amendments set forth in the Release (the "Proposal"). We find the bulk of the Proposal to be unnecessary, given the sophistication of the parties investing in private funds.[2] We believe that its application would be overly burdensome to fund managers, costly to managers and investors and unfair to fund managers in certain respects.[3] It will also require additional resources of the Commission to inform the private fund marketplace of the new rules, answer questions about the application of the new rules to specific circumstances (through no action letters or otherwise) and enforce the rules, possibly at the expense of protecting retail investors.[4]

The investment management industry is truly global. We believe that the Proposal, on balance, would result in a competitive disadvantage to U.S. private fund managers who would need to comply with the Proposal, as compared to their counterparts who would not be subject to many of these new burdens. The management of private funds is not only global, but also is portable, as is well illustrated by the recent flight of private fund managers from higher taxed jurisdictions to Florida and Puerto Rico, which present lucrative tax benefits. In this regard, we could foresee a situation where rising costs and burdens make the U.S. less desirable as a jurisdiction from which to manage private funds.[5]

In response to the Commission's first question in Part II of the Release (which asks whether certain reforms proposed in the Release should apply in other contexts), we note that the Proposal would target managers of private funds in ways that would not apply

[1] Release No. IA-5955, File No. S7-03-22
[2] As per Commissioner Hester M. Peirce's Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking, located at https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922, we agree that the Proposal "embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationships with private funds." We also concur that "the proposal's focus on protecting private fund investors by shaking information loose from what we deem to be uncommunicative private funds and shutting down practices we deem to be unfair is a departure from the Commission's historical view that these types of investors can fend for themselves." (See prior link in this footnote.)
[3] We will defer to others, such as law firms, to comment on the legality of the Proposal. See for example the comment letter submitted by Harvey L. Pitt, dated April 18, 2022. https://www.sec.gov/comments/s7-03-22/s70322-20123886-280060.pdf
[4] See Commissioner Hester M. Peirce's Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking, located at https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922
[5] https://www.forbes.com/sites/jackkelly/2021/01/06/florida-is-fast-becoming-the-second-home-for-wall-street/?sh=7a7a6a8a443f; https://www.bloomberg.com/news/articles/2021-05-10/hedge-funds-facing-biden-tax-threat-grab-toehold-in-puerto-rico

to other investment advisers (including those that advise smaller, retail accounts). As purchasers of securities, investors in private funds are already protected in ways that managed account clients are not. If fund managers engage in egregious conduct, they may be more vulnerable to class action litigation under the securities laws, and smaller investors who may not have the wherewithal to sue individually may ride the coattails of larger institutional investors. We would turn the question back to the Commission to answer why private fund managers *should* be burdened in ways that other advisers are not, especially given their investors' sophistication and the protections that the investors are afforded under the U.S. securities laws?[6]

Although we have commented on a few specific items that we find especially worrisome, the HFA urges the Commission to step back and consider the breadth of recent rulemaking activity that significantly impacts the private fund industry and the short timeline for industry participants (particularly membership organizations that seek the input of their constituents) to respond to these important (and lengthy) proposals. The HFA encourages the Commission to re-open the comment period for the Release, as well as the "Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers" release.[7]

Quarterly Statement Requirements

The HFA views the additional quarterly statement requirements (listed in Part A of the Release) as a solution looking for a problem. Prospective investors may request bespoke reports prior to investing and, once invested, can require the fund to provide reports they find useful on an ongoing basis. Private fund managers, as businesspeople, are incentivized to provide information their potential and committed investors request. Therefore, we oppose additional cookie-cutter disclosures that fund managers will need to dedicate time and money toward fulfilling. We believe that the additional reporting will cause additional work for operations teams and over-burden smaller advisers.

As stated in the Release, "enhanced competition from additional transparency may lead to lower fees or may direct investor assets to different funds, fund advisers, or other investments." While we agree that the private investment fund marketplace and its players will benefit from greater transparency, we believe that the general public should have additional access to information about private funds (e.g., on their websites or through social media). Members of the media could then aggregate and synthesize data for the benefit of the public at large. Currently, private fund advisors offering funds without the use of general solicitation are very limited in what they can release to the public. The HFA would welcome the opportunity to evaluate proposals to allow private fund managers to disseminate additional information to the general public. We believe that transparency has been greatly hindered by (i) lingering uncertainty and unnecessary complication in the application of Rule 506(c), promulgated under the Securities Act of 1933,[8] and (ii) the fear of prosecution for misstatements, including under Rule 206(4)-8 of the Investment Advisers Act, which can result in liability for "negligent fraud."[9] The HFA believes that the way to address a lack of transparency in the private fund industry is not to require additional reporting to the Commission or to existing or prospective investors, but to provide greater avenues for fund managers to make information about their private funds available to the general public and then allow prospective accredited investors, armed with this new knowledge, to invest their capital as they see fit.

Mandatory Audit Requirement (Proposed Rule 206(4)-10

Although there are open questions raised by the SEC in the Release,[10] the current Proposal would require a registered investment adviser to cause each private fund it advises to obtain an audit of its financial statements by an independent public accountant annually. We believe that the goals of the Proposal, which are to "protect the fund and its investors against the misappropriation of fund assets" are similarly achieved by surprise verification. Moreover, small funds, including some that may be characterized as "SPVs," and their investors would be significantly harmed by having to undergo (and pay for) an annual audit, rather than being able opt for cheaper surprise verifications by an audit firm, which is permitted under the current rules.[11] Is the Commission seeking to put its registrants who manage these vehicles at a substantial disadvantage to their unregistered (and possibly non-U.S.) competitors, who may not need to seek an audit *or* surprise verification? Again, private fund investors are sophisticated and able to seek out and invest in funds that provide an annual audit if this is important to them.

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[6] The private fund industry has also been targeted with the "hedge fund anti-fraud rule" which imposes liability upon private fund managers but not other investment advisers. See Rule 206(4)-8 under the Investment Advisers Act. The HFA questions why private funds and their managers are again being singled out.
[7] Please see our prior request for additional time to comment at https://www.sec.gov/comments/s7-01-22/s70122-20120591-272781.pdf
[8] For a discussion about the relative success or failure of market participants to utilize Rule 506(c), see the SEC's release regarding Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, which notes: "The vast majority of capital raised in this market, approximately $1.5 trillion (average proceeds of $26.5 million), was raised under Rule 506(b). Out of the remaining amount, offerings under Rule 506(c) raised approximately $66 billion (average proceeds of $17 million) and offerings under Rule 504 raised approximately $228 million (average proceeds of $0.6 million)." https://www.sec.gov/rules/proposed/2020/33-10763.pdf
[9] See https://www.ropesgray.com/~/media/Files/articles/2007/10/rick-marshall-analyzes-implications-of-secs-anti-fraud-rule.pdf As noted in this article, "a violation of the Rule would not require a showing that an adviser acted with scienter. Thus, in stark contrast to Rule 10b-5, an adviser could violate the Rule with conduct that is merely negligent. This departure from Rule 10b-5 jurisprudence represents one of the most significant and controversial aspects of the Rule." (footnotes omitted).See for example the following: https://www.sec.gov/litigation/complaints/2018/comp-pr2018-190.pdf where the Commission brought charges against a fund manager under Section 206(4).
[10] Open issues for which the SEC has solicited comments include whether the Proposal should also apply to other advisers and other categories of pooled investment vehicles.
[11] In the Release, the Commission estimates that audit fees would tend to vary over an estimated range from $15,000 to $300,000, and that some fund audit fees would be higher or lower than this range.

The Proposal would likely harm investors in funds that are winding down and left with just a small amount of illiquid assets (which may be held for multiple years pending the resolution of an event). It may be economically more advantageous for funds in this situation to fire-sell the remaining assets, rather than pay audit fees over an extended period.

Prohibited Activities (Proposed Rule 211(h)(2)-1)

Proposed Rule 211(h)(2)-1 would prohibit an investment adviser to a private fund, directly or indirectly, from engaging in certain activities that are not currently prohibited (including the reimbursement of certain categories of expenses and changes to the minimum standard of care for investment managers to the fund). The HFA is opposed to all of these new requirements. As a general matter, they restrict the ability of market participants to bargain for arrangements that work for the parties. As a practical matter, we believe that these new rules will be difficult to implement, especially for existing funds, which would need to re-write their offering and governing documents to contemplate these new requirements (including changes to the provisions on indemnification and expense reimbursement). This would likely involve engaging securities lawyers (possibly in multiple jurisdictions) and seeking input from auditors and fund administration firms, among others. Those costs, which are likely to be substantial, will ultimately be borne by fund investors in many cases.

The Proposed Rule shifts certain costs and risks from the fund to its manager, and some managers (especially those who have had positive recent performance and therefore have greater bargaining power) may respond by increasing their fees to offset potential costs or the loss of existing revenue streams. Some managers will also likely seek greater levels of insurance (which may become more expensive as demand increases), and many fund managers charge back all or a portion of the premiums to the funds they manage and indirectly their investors.

As stated in the Release, the proposed prohibited activities rule would not apply to a registered offshore adviser's private funds organized outside of the United States, regardless of whether the private funds have U.S. investors. This puts U.S. managers at a distinct competitive disadvantage to non-U.S. managers. While managers to existing funds did not expect to be subject to the costs and risks imposed by the Release (if adopted), adopting this rule will disproportionately burden smaller, emerging managers, who may be working with tighter budgets and less reserves.

The proposal to eliminate the ability for investment advisers (potentially both registered and unregistered) to 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, *negligence*, or recklessness in providing services to the private fund is especially concerning to the HFA. Imposing a negligence standard seems unworkable in practice. Entities are formed under the laws of the 50 U.S. states and a wide range of non-US jurisdictions. Some presumably entitle directors, general partners, managing members and others to exculpation and indemnification as a matter of the entity's governing law. Employees of investment advisers (who typically would not be able to bear the costs of making a fund whole for a multimillion dollar loss), could commit an honest mistake and be found to have acted negligently. Contrary to the language of the Release, we would not characterize ordinary negligence as "misconduct." Indeed, because establishing a prima facie case of negligence is a low standard, adopting this standard could present a huge opportunity for plaintiffs' counsel to declare open season on private fund managers and their personnel. As a matter of fairness, as noted above, we ask rhetorically why should they be subject to increased liability as compared to other investment advisers? Presumably, investment advisers will need to increase their fees to compensate themselves and their personnel for these added risks. Imposing liability upon investment managers to private funds under a negligence standard will likely also lead to a flurry of litigation, which may be an unintended consequence of the Proposal.

Conclusion

We appreciate the opportunity to comment on the proposal set out in the Release. Although we have not commented on every aspect of the Release, we would hope that the Commission would reconsider these sweeping changes and, at the very least, allow those who will be impacted with a greater opportunity to submit comments. We will be available to the Commission or its Staff if we can be of assistance.

Sincerely,

Hedge Fund Association

Mitch Ackles
Global President