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Submitted by SEC Webform (http://www.sec.gov/rules/submitcomments.htm)

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

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

Dear Ms. Countryman:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am writing in response to U.S. Securities and Exchange Commission ("SEC" or the "Commission") Release No. IA-5955, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews* (the "Proposal"), in which the SEC proposes new rules applicable to investment advisers to private funds ("PFAs").[2]

Although private funds may once have been the exclusive province of well-heeled, sophisticated investors, today, they "play an increasingly important role in the lives of everyday Americans saving for retirement or college tuition."[3] Retail investors commonly have exposure to private funds through pension and other retirement plans,[4] and recent shifts in the regulatory environment have led some institutions to begin testing the waters to offer retail investors access to private equity vehicles.[5] At the same time, and as acknowledged in the Proposal, "private fund investments are often opaque" and "advisers frequently do not provide investors with sufficiently

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1 Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

2 The Proposal is available at https://www.sec.gov/rules/proposed/2022/ia-5955.pdf.

3 Proposal at 8.

4 *Id.*

5 *See* Adam Lewis, *Opaque private equity is marketing to retail investors despite pushback*, PitchBook (June 2, 2021), https://pitchbook.com/news/articles/private-equity-marketing-to-retail-investors-despite-pushback; Adam Lewis, *Investors are wary about private equity's new access to 401(k)s*, PitchBook (June 18, 2020), https://pitchbook.com/news/articles/investors-wary-about-private-equitys-401ks.

detailed information" to assess, compare, and make informed decisions about their private fund investments.[6] This lack of transparency exacerbates the deficiencies recently observed by the Division of Examinations, including PFAs failing to act consistently with material disclosures, providing misleading track records, failing to maintain records to substantiate their performance claims, failing to conduct appropriate diligence into investments, and attempting to use potentially misleading hedge clauses in investor contracts and disclosures.[7] The lack of transparency, accountability, and protection from conflicts of interest in private funds can have devastating effects on investors' life savings.[8]

The Proposal is designed to provide greater transparency to private fund investors about costs and performance, as well as to impose greater accountability on PFAs and guard against conflicts of interest. More specifically, the Proposal would require PFAs that are registered or required to be registered with the SEC: to prepare and distribute quarterly statements to private fund investors that include detailed and standardized information about fees paid to the PFA, other costs borne by the fund, and the performance of the fund;[9] to obtain an annual audit of the fund's financial statement by an independent accountant that is registered with the Public Company Accounting Oversight Board ("PCAOB");[10] and to obtain a fairness opinion from an independent third party in connection with certain adviser-led secondary transactions.[11] The Proposal would also prohibit all PFAs, regardless of registration or reporting status, from engaging in certain activities that the SEC deems "contrary to the public interest and the protection of investors."[12] Finally, the Proposal would prohibit all PFAs from providing preferential terms to certain investors regarding redemption or information about portfolio holdings or exposures, and from providing other forms of preferential treatment without disclosing such arrangements to prospective and current investors.[13]

NASAA generally supports the Proposal and we encourage its adoption, with certain revisions. We agree with the proposed quarterly statement and annual audit requirements, but we

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6 Proposal at 9-10.

7 *See* SEC Div. of Exams, *Risk Alert: Observations from Examinations of Private Fund Advisers* (Jan. 27, 2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf; SEC Div. of Exams, *Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds* (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

8 *See*, *e.g.*, Press Release, NASAA, NASAA Announces State Enforcement Actions Against GPB Capital Holdings for Allegedly Defrauding Investors in $1.8 Billion Private Offering Scheme (Feb. 4, 2021), https://www.nasaa.org/56683/state-enforcement-actions-announced-against-gpb-capital-holdings-for-allegedly-defrauding-investors-in-1-8-billion-private-offering-scheme/; Press Release, SEC, SEC Charges Investment Adviser and Others With Defrauding Over 17,000 Retail Investors (Feb. 4, 2021), https://www.sec.gov/news/press-release/2021-24.

9 *See* proposed rule 211(h)(1)-2, Proposal at 334-38.

10 *See* proposed rule 206(4)-10, Proposal at 328-30.

11 *See* proposed rule 211(h)(2)-2, Proposal at 339-40.

12 Proposal at 132; proposed rule 211(h)(2)-1, Proposal at 338-39.

13 *See* proposed rule 211(h)(2)-3, Proposal at 340-41.

believe these requirements should also apply to exempt reporting advisers ("ERAs"). We also agree with the Proposal that certain conflicts cannot be effectively managed, and that PFAs should be prohibited from engaging in certain sales practices, conflicts of interest, and compensation schemes. The enumerated prohibitions address activities that place the PFA's interests ahead of the fund's, or certain investors' interests ahead of other investors. This is incompatible with the fiduciary duties to which PFAs are required to adhere.

I. Private Fund Quarterly Statements – Proposed Rule 211(h)(1)-2

The Proposal would require all PFAs that are registered or required to be registered with the SEC to provide quarterly statements to investors that include detailed information about fees, expenses, and the performance of the private fund.[14] NASAA supports this part of the Proposal. We believe that requiring PFAs to prepare and distribute the proposed statements quarterly strikes the appropriate balance between investor protection and adviser burden. More frequent, monthly statements may not be necessary for most funds. However, a semi-annual or annual statement would likely fail to provide investors with timely information on which to base their investment decisions.

The Proposal asks whether PFAs should be required to provide investors with personalized information that considers their individual ownership stakes in the fund.[15] Although investors would likely benefit from personalized statements, we believe that the detailed contents of the quarterly statements as proposed, coupled with the proposed prohibition on undisclosed preferential treatment, will adequately empower investors to use fund-wide data to perform their own personal calculations.

As proposed, the quarterly statements would include the compensation paid to a sub-adviser that is a related person of the PFA. The Proposal asks whether the proposed statements should also include information about the compensation paid to non-related person sub-advisers and, if so, how it should be reflected in the statement.[16] We see no reason to treat compensation paid to a non-related person sub-adviser differently from any other expenses borne by the fund and its investors. This information needs to be included in the statement so that investors have an accurate and complete accounting of fees and expenses.

The Proposal also asks whether hedge fund advisers should be required to include the dollar amount of any soft-dollar or similar benefits provided by broker-dealers that execute trades for the fund, or any benefits provided by hedge fund prime brokers.[17] These benefits should also be included on the quarterly statements. Soft-dollar benefits can be a significant benefit (if the adviser receives soft-dollar benefits) or an indirect cost (if the adviser does not receive soft-dollar benefits) to investors in the fund. Disclosure of soft-dollar and prime brokerage benefits is also important

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14 Proposal at 17-18.

15 *Id.* at 21.

16 *Id.* at 23.

17 *Id.* at 37.

because they carry the potential for conflicts of interest to the extent that they could skew a PFA's decisions in terms of whether to use a particular broker-dealer or whether the PFA is fulfilling its obligation to obtain best execution for the fund. We believe this information is necessary for an investor to have a complete picture of the costs and benefits associated with the PFA's management of the fund.

Finally, the proposed quarterly statement requirement should also apply to ERAs. Although ERAs tend to be smaller than SEC-registered PFAs, ERAs represent a substantial portion of the total assets under management attributable to private funds generally. Based on Form ADV data contained in the Proposal, ERAs represented approximately 22% of all private fund assets under management as of September 30, 2021.[18] All private fund investors should be entitled to the same transparency and accountability from their PFAs, regardless of the size of the fund at issue or the PFA's total assets under management.[19]

II. <u>Private Fund Adviser Audits – Proposed Rule 206(4)-10</u>

The Proposal would require all PFAs that are registered or required to be registered with the SEC to cause each private fund they manage to undergo a financial statement audit by an independent public accountant registered with the PCAOB at least annually and upon liquidation.[20] The audited financial statements would be required to be distributed "promptly after the completion of the audit."[21] Further, the auditor would be required to notify the Commission "promptly upon issuing an audit report to the private fund that contains a modified opinion" and "[w]ithin four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed."[22]

NASAA strongly supports this requirement. The proposed audit requirement would provide protection for the fund and investors against misappropriation of fund assets. It would also serve to correct and clarify the PFA's valuation of private fund assets, which often forms the basis for calculating the PFA's compensation. As the Proposal acknowledges, the longer a

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18 *See id.* at 189.

19 *See* 17 CFR 275.203(m)-1 (exempting from registration an investment adviser with its principal office and place of business in the U.S. that acts solely as an investment adviser to one or more qualifying private funds and manages private fund assets of less than $150 million). The Proposal also asks whether the quarterly statement and financial statement audit requirements should apply to pooled investment vehicles that rely on the exclusion from the definition of "investment company" in section 3(c)(5)(C) of the Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(5)(C) (*i.e.*, real estate investment trusts ("REITs")). *See* Proposal at 22, 114. Although not the main focus of this comment letter, REITs raise similar concerns about a lack of transparency and conflicts of interest. *See* SEC, *Investor Bulletin: Non-traded REITs* (Aug. 31, 2015), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_nontradedreits.html. As such, we would support the imposition of these requirements on REITs in addition to private funds.

20 Proposal at 99.

21 *Id.*

22 Proposed rule 206(4)-10(e), *id.* at 329.

misrepresentation, omission, or even outright misappropriation goes undetected, the harder it is to remediate or correct.[23] Requiring a financial statement audit at least annually is likely to prove to be an important tool to detect fraud, as well as to deter it.

As with the quarterly statement requirement, we believe this requirement should also apply to ERAs. In order to rely on the *NASAA Registration Exemption for Investment Advisers to Private Funds Model Rule*, PFAs to certain funds that are excluded from the definition of an investment company under Section 3(c)(1) of the Investment Company Act of 1940 are required to undergo similar audits.[24] As such, we believe that many ERAs likely already obtain annual audits, which mitigates the potential burden on ERAs.

As proposed, the final rule would require the audit to be performed by an independent accountant registered with the PCAOB and for the financial statements to be prepared in accordance with U.S. Generally Accepted Accounting Principles ("GAAP"). We believe that these standards are warranted in light of both the complexities that may be involved in private fund audits and the public interest in safeguarding investor assets. PCAOB-registered accountants provide a widely recognized and uniform standard of expertise that would reduce instances of possibly inferior audits. This approach is also consistent with the Commission's reporting requirements in general. For example, when the Commission requires a balance sheet as part of Schedule G of Form ADV, the balance sheet must always be prepared in accordance with GAAP, which have been developed by the American Institute of Certified Public Accountants and the Financial Accounting Standards Board.[25]

Finally, the Commission should, as proposed, require the independent public accountant completing the audit to notify the Division of Examinations "promptly" in the event of a modified opinion or within four days in the event of the termination of the auditor. Both events constitute serious red flags that warrant early notice to regulators. The issuance of a modified opinion often means there are material misstatements in the financial statements or other documents that are the subject of the audit, which may warrant an examination by the SEC or other regulators. The termination of an auditor also often signals serious issues.[26] In the latter case, it is critical that

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[23] *See* Proposal at 110.

[24] *NASAA Registration Exemption for Investment Advisers to Private Funds Model Rule* ("NASAA Private Fund Adviser Exemption") (amended Oct. 8, 2013), https://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Registration-Exemption-for-Investment-Advisers-to-Private-Funds-Model-Rule-Amended-Oct.-8-2013.pdf.

[25] *See* Schedule G of Form ADV, https://www.nasaa.org/wp-content/uploads/2011/08/25-FormADVPartIIScheduleG.pdf.

[26] *See* Jeff Benjamin, *GPB announces another delay in release of audited financials*, InvestmentNews (Nov. 27, 2019), https://www.investmentnews.com/gpb-announces-another-delay-in-release-of-audited-financials-170779; Mass. Sec. Div., Registration, Inspections, Compliance & Examinations Section Newsletter at 3 (Dec. 2018), https://www.sec.state.ma.us/sct/sctpdf/newsletters/Securities-newsletter-Dec-2018.pdf.

regulators receive notice early, so that they can take action to uncover potential fraud and mitigate investor losses.[27]

In order to ensure the SEC's "[t]imely receipt of this information," the time in which the auditor must notify the SEC that it has issued a modified opinion should be more specifically defined. This notice requirement does not implicate a similar need for flexibility as the timing for a PFA's distribution of its audited financial statements.[28] Rather than setting a specific deadline for distribution of the audited financial statements (*e.g.*, "within 120 days of a private fund's fiscal year end"), the Proposal would require "prompt[]" distribution in order to allow PFAs the flexibility to conduct an audit that is appropriate for the structure of the fund, as well as to account for potential disruptions that are out of the PFA's control.[29] These considerations do not apply to the auditor's notice of a modified opinion because the audit would by definition have been completed at the time the auditor would be required to provide notice.

Accordingly, we recommend that the auditor be required to provide notice that it has issued a modified opinion "as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next business day)." This standard would remove the inherent subjectivity from the proposed open-ended "prompt[ness]" standard and help the SEC timely evaluate the need for an examination or investigation of the PFA. It would also be consistent with the existing requirements for issuers to report non-intentional selective disclosure of material non-public information in Regulation FD.[30] When the SEC adopted the substantially identical requirement in Regulation FD, it noted its belief that "the 24-hour requirement strikes the appropriate balance between achieving broad, non-exclusionary disclosure and permitting issuers time to determine how to respond after learning of the non-intentional selective disclosure."[31] We believe that this approach would achieve a similar balance in this context and would materially enhance the Proposal.

We note that the Proposal's description of this requirement could result in some ambiguity about the scope of a PFA's obligations. Specifically, the Proposal states that "[t]he proposed rule would require an adviser to enter into, or cause the private fund to enter into, a written agreement with the independent public accountant performing the audit to notify the Commission . . . ."[32] We

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27 The four-day notice requirement for the latter tracks with a similar requirement in NASAA's model custody rule. *See NASAA Custody Requirements for Investment Advisers*, Model Rule 102(e)(1)-1(b)(4)(E) (amended Apr. 15, 2013), https://www.nasaa.org/wp-content/uploads/2013/04/NASAA-Model-Custody-and-Recordkeeping-Rules1956-and-2002-04-15-2013.pdf.

28 *See* Proposal at 108-09.

29 *See id.* at 108.

30 *See* 17 CFR 243.100(a)(2); 17 CFR 243.101(d) (defining "promptly" to mean "as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange) after a senior official of the issuer (or, in the case of a closed-end investment company, a senior official of the issuer's investment adviser) learns that there has been a non-intentional disclosure . . . .").

31 Final Rule, *Selective Disclosure and Insider Trading*, Rel. No. 33-7881, 65 FR 51715, 51722-23 (Aug. 24, 2000), https://www.govinfo.gov/content/pkg/FR-2000-08-24/pdf/00-21156.pdf.

32 Proposal at 111.

encourage the Commission, in any release accompanying the final rule, and in any subsequent guidance, to make it clear that PFAs' obligations do not conclude upon entering an agreement with the auditor and a PFA will not be in compliance with the audit rule if the auditor fails to notify the Commission as required.

III. Private Fund Adviser Prohibited Activities – Proposed Rule 211(h)(2)-1

The Proposal would broadly prohibit all PFAs, regardless of registration or reporting status, from engaging in certain transactions and compensation practices. NASAA agrees that the enumerated prohibited practices are likely to incentivize PFAs to place their interests ahead of their funds' or investors' interests, which can result in fraud or other investor harm. Specifically, we agree that certain of these practices, such as passing on regulatory and compliance expenses and non-pro rata fee allocation, are likely to cause smaller investors who are not able to negotiate preferential terms with PFAs to bear an unfair proportion of fund costs. As such, the Proposal appropriately prohibits these activities for all PFAs, not only those registered or required to be registered with the SEC.

We do, however, disagree with the Proposal to the extent that the prohibition on a PFA charging fees to a portfolio investment for services that it does not, or does not reasonably expect to, render would not apply if the PFA "shifts 100% of the economic benefit" of any such fee to the private fund investors.[33] While this would mitigate the conflicted incentives of accelerated compensation, it is not clear whether it would compensate investors for the potentially lower return on their investment.[34] Further, the Proposal recognizes that this approach would also disadvantage "tax-sensitive" investors who might waive the right to receive their share of the benefit, and raises difficult questions about what to do with their share.[35] As such, we believe the best approach is for PFAs to avoid accelerated fees entirely and be compensated only for services actually performed. As fiduciaries, investment advisers are generally not permitted to collect and fail to return unearned fees for advisory services. Similarly, PFAs must act in the best interest of the fund and its investors. Charging a portfolio company – and thus, indirectly, charging the fund and its investors – for services not actually performed is incompatible with that duty.

The Proposal asks whether these prohibitions should apply only to a PFA's private fund clients or to all of the adviser's clients.[36] We do not believe that the scope of the proposed rule should be expanded beyond the private fund context. An investment adviser that has non-private fund clients will not be eligible for the applicable exemption at either the state or federal level.[37]

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[33] *See id.* at 138.

[34] *See id.* at 137.

[35] *Id.* at 139.

[36] *Id.* at 134.

[37] *See* NASAA Private Fund Adviser Exemption, *supra* note 24, at (a)(2) ("'Private fund adviser' means an investment adviser who provides advice solely to one or more qualifying private funds."); 17 CFR 275.203(m)-1(a)(1) (to qualify for the exemption, an investment adviser must "[a]ct[] solely as an investment adviser to one or more qualifying private funds").

As a result, any such PFA will be subject to regulation under existing and well-established rules and regulations, and it is unnecessary to extend the proposed rule beyond its intended context.

IV. Preferential Treatment – Proposed Rule 211(h)(2)-3

The Proposal would prohibit all PFAs, regardless of registration or reporting status, from providing preferential terms to certain investors regarding redemptions or information about the fund's holdings and exposures.[38] The Proposal would also prohibit any other preferential treatment unless it is disclosed to current and prospective investors in the fund.[39] We understand that side letters are relatively common and that PFAs may have strategic reasons for granting preferential redemption or informational terms. However, as fiduciaries to *all* investors in the fund, PFAs should not be permitted to grant some investors an advantage at the expense of other investors. As such, we fully support this aspect of the Proposal.

V. Conclusion

NASAA appreciates the steps the Commission is proposing to take to increase transparency and accountability in private funds and to guard against harmful conflicts of interest. For the reasons discussed above, NASAA supports the Proposal and encourages its adoption, with certain revisions as described above. Thank you for considering these views. NASAA looks forward to continuing to work with the Commission in the shared mission to protect investors. Should you have questions, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Sincerely,

Melanie Senter Lubin

Melanie Senter Lubin
NASAA President and
Maryland Securities Commissioner

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38 Proposal at 162.

39 *Id.*