April 25, 2022

Ms. Vanessa Countryman
Secretary, Office of the Secretary
US Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

RE: Comments on SEC Release Nos. IA-5955; File No. S7-03-22; RIN 3235-AN07; Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

Dear Ms. Countryman:

On February 9, 2022[1], the US Securities and Exchange Commission ("SEC" or "Commission") proposed new rules ("Proposed Rules" or "Proposal") under the Investment Advisers Act of 1940 ("Advisers Act") and the Investment Company Act of 1940 ("Investment Company Act") to require that registered investment advisers to private funds provide transparency to their investors regarding the full cost of investing in private funds and the performance of such private funds. The proposed rules would require an adviser to obtain an annual financial statement audit of each private fund it advises and, in connection with an adviser-led secondary transaction, a fairness opinion from an independent opinion provider. In addition, the proposed rules would prohibit all private fund advisers, including those that are not registered with the Commission, from engaging in certain sales practices, conflicts of interest, and compensation schemes that are deemed contrary to the public interest and the protection of investors. Under the Proposed Rules, all private fund advisers would be prohibited from providing preferential treatment to certain investors, unless an adviser discloses such treatment to other current and prospective investors. Corresponding amendments to the Advisers Act books and records rule are also included in the proposal. Finally, the Proposal includes amendments to the Advisers Act compliance

[1] Published in the *Federal Register* March 24, 2022.

rule, which would affect all registered investment advisers, requiring written documentation of an adviser's annual review of policies and procedures.

NRS, a ComplySci Company, appreciates the opportunity to comment on this important Proposal and respectfully submits the following response.

Background on NRS and NRS Clients

Since 1983, NRS has provided its clients with exceptional compliance consulting services, compliance technology solutions, education conferences and seminars. In addition, NRS created and sponsors, in conjunction with the Investment Adviser Association, the Investment Adviser Certified Compliance Professional ("IACCP®") certification program, which has produced more than 1,000 designees. NRS serves more than 3,000 investment advisers, broker-dealers, and investment companies ranging from small firms to the largest global investment management complexes and myriad of firms in between.

Over our 39 years of providing consulting services, NRS has continually interacted with investment advisers of all sizes through our conferences, seminars, and consulting relationships. We have learned that regulatory clarity and precision is a strong determinant of effective compliance. Investment advisers, broker-dealers and other financial institutions must clearly understand the expectations of regulators and their obligations under applicable regulations in order to design and implement effective compliance controls that ultimately serve to protect investors.

It has also been our experience that many small and mid-sized advisers believe that they are disproportionately affected by the cost of complying with new regulations, many of which address risks far more common among firms much larger than they are. NRS commends the SEC for proposing these rules and seeking to address and limit certain practices giving rise to conflicts of interest for private fund advisers and increasing the level of transparency for all fund investors. NRS continues to believe that markets are most efficient when all participants possess the same foundational level of material information. We also believe that, in general, disclosure-based compliance mechanisms continue to be preferrable to proscriptive efforts.

As such, we urge the Commission to embrace an approach that, where appropriate, differentiates among private funds that rely on the 3(c)(1) exemption from registration under the Investment Company Act from those relying on the 3(c)(7) exemption. NRS believes that this approach accomplishes the

Commission's goals while minimizing the impact of new regulatory requirements by balancing the need to implement additional controls to protect some investors and retaining maximum flexibility for investors who do not require those protections.

NRS appreciates the opportunity to comment on the Commission's Proposed Rules; our responses to select questions included in the Proposal follow.

Section II. A. Quarterly Statements

Question: *Should we, as proposed, require advisers to private funds to prepare a quarterly statement providing standardized disclosures regarding the cost of investing in the private fund and the private fund's performance and distribute the quarterly statement to the fund's investors?*

NRS Response: NRS generally agrees with the Commission's objective of protecting smaller, retail-type investors in private fund structures. Such investors may not have sufficient bargaining power and/or investment acumen to independently request and evaluate fee and expense information and may, consequently, receive less transparency than large or institutional investors in the same funds or similar funds. However, NRS believes that larger, sophisticated investors do not require that same level of protection and are well-positioned to negotiate all important investment terms, including but not limited to, cost and expense disclosures. Therefore, NRS recommends that the proposed standardized disclosures be limited to funds relying on the 3(c)(1) exemption from registration under the Investment Company Act and not extended to funds relying on the 3(c)(7) exemption from registration under the Act. NRS believes that this approach will have the effect of providing more flexibility to investors and firms who do not require additional protections to select their own reporting formats and frequency of delivery, while affording a level of transparency to those who do require additional protections. Alternatively, the Commission could consider a higher investor qualification threshold (e.g., income, investment amount and/or net worth based) for exempting a private fund adviser from quarterly statement disclosures.

Questions: *The proposed rule would require advisers to prepare and distribute a quarterly statement disclosing certain information regarding a private fund's fees, expenses, and performance. Are there alternative approaches we should require to improve investor protection and bring greater efficiencies to the market? For example, should we establish maximum fees that advisers may charge at the fund level?*

Should we prohibit certain compensation arrangements, such as the "2 and 20" model? Should we prohibit advisers from receiving compensation from portfolio investments to the extent they also receive management fees from the fund? Should we require advisers to disclose their anticipated management fee revenue and operating budget to private fund investors or an LPAC or other similar body (despite the limitations of private fund governance mechanisms, as discussed above) on an annual or more frequent basis? 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)? 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? Should we prohibit certain expense practices or arrangements, such as expense caps provided to certain, but not all, investors?

NRS Response: NRS believes that disclosure-based compliance mechanisms are preferable to prohibition-based ones in this area. Specific prohibitions on fee structures may result in fewer options for investors and stifle financial product innovation in general. Private fund economics span a wide spectrum, and what works for a particular structure may not be financially feasible for another. We urge the Commission to let private fund investors and fund advisers negotiate and determine fee structures as appropriate to the unique circumstances of a particular deal or private fund.

Questions: *Do any of the proposed requirements impose unnecessary costs or compliance challenges? Please provide specific data. Are there any modifications to the proposal that we could make that would lower those costs or mitigate those challenges? Please provide examples.*

NRS Response: NRS believes that the requirement for quarterly statements will add additional compliance costs to all private funds. However, such costs are likely not going to have an equal impact across the industry. Those private fund advisers who employ the services of third-party administrators or vendors with similar service deliverables will be in a better position to streamline the process for newly required deliverables, albeit at additional costs. However, small private fund advisers who do not use third-party administrator services will bear a more direct burden of producing quarterly statements. This will likely result in the need to either hire additional staff or consider the retention of third-party service providers. Moreover, private fund advisers that employ specific fund structures, such as single-investment funds, will have a greater burden of producing multiple quarterly statements. Additional

costs of these deliverables could be passed on to investors in current and future funds, increasing costs to private fund advisers and investors alike.

Questions: *Should the proposed rule require advisers to include performance information in investor quarterly statements? Why or why not?*

Although some investors receive certain annual performance information about a private fund if that fund is audited and distributes financial statements prepared in accordance with U.S. GAAP, we believe that the proposed rule's performance information would be helpful for private fund investors because it would require performance information to be reported at more frequent intervals in a standardized manner. Do commenters agree?

What, if any, burdens would be associated with this aspect of the proposed rule? How can we minimize any associated burdens while still achieving our goals?

NRS Response: NRS believes that requiring quarterly performance information to be provided to fund investors will impose a significant burden on many private fund advisers, especially those invested in Financial Accounting Standards Board ("FASB") Fair Valuation Measurement (Topic 820) level 2 and level 3 classified securities. Based on the experiences of our many private fund adviser clients, we see annual valuation processes requiring significant time, effort, and coordination with independent auditing firms. While it is true that some private fund advisers do provide more frequent performance results, those reports tend to be unaudited and informal and NRS believes that providing such interim reports is not currently a widespread industry practice. We believe that requiring annual performance results to be distributed by private fund advisers in a standardized format would strike a favorable balance and achieve process alignment with the audit exemption approach relied upon by many private fund advisers and included in the current requirements of Rule 206(4)-2 ("Custody Rule").

Section II. B. Mandatory Private Fund Adviser Audits

***Questions*:** *The proposed audit rule bears many similarities to provisions of the custody rule; however, one notable difference is that there would be no option to, instead, undergo a surprise examination and rely on a qualified custodian to deliver quarterly statements. What would be the impact on advisers to private funds that are not relying on the custody rule's audit provision? There also are no exceptions from the proposed rule, as there are in the custody rule, such as the exception from the surprise*

examination requirement for advisers whose sole basis for being subject to the rule is because they have authority to deduct their advisory fees. What would be the impact on advisers to private funds that are relying on this and other exceptions?

NRS Response: The Commission's proposed new Advisers Act Rule 206(4)-10 ("Audit Rule") would require, in part, that private fund advisers registered, or those required to be registered, with the Commission, to obtain an annual audit of the financial statements of the private funds they manage. If an adviser does not control the private fund and is neither controlled by nor under common control with the fund, the Audit Rule would instead require the adviser to take all reasonable steps to cause its private fund client to undergo an audit that would satisfy the Audit Rule.

NRS agrees with the Commission's objective of protecting smaller, retail-type investors in a private fund. Such investors may not have sufficient bargaining power and/or investment acumen to independently request and negotiate for mandatory audits. However, NRS believes that larger, sophisticated investors do not require that same level of protection and are well-positioned to negotiate all important investment terms, including but not limited to, financial audit requirements. Therefore, NRS recommends that the proposed annual audit requirements be limited to funds relying on the 3(c)(1) exemption from registration under the Investment Company Act and not extended to funds relying on the 3(c)(7) exemption from registration under the Investment Company Act, with the additional caveat that if the private fund provides audited financials to any investor, the same information must be shared with all investors in the fund.

In addition, NRS believes that the proposed Audit Rule creates serious barriers to entry for registered investment advisers aspiring to enter the private fund space. NRS has multiple clients that are small private fund advisers and/or those interested in entering the market. Although many chose to conduct independent financial audits under the Custody Rule, others have opted to rely on surprise examinations to meet the Custody Rule requirements. Private funds generally decide whether to use a financial audit or a surprise examination due to large investor requirements and costs to the fund. Mandating the Audit Rule requirements would increase barriers to entry and increase costs that are ultimately paid by the private fund's investors.

NRS has also evidenced a trend in private fund advisers utilizing single investment funds. We believe the cost associated with performing a financial audit on each such fund would create substantial cost to the funds and their underlying investors. If the Audit Rule is adopted, NRS recommends utilizing a consolidated audit approach with an exception from the Audit Rule for smaller advisers to private

funds using a similar approach, as discussed above. In this manner, NRS believes that the objective of additional protections for investors is accomplished at potentially lower cost to private funds, private fund advisers and investors.

As previously stated, the Audit Rule proposes to require advisers to take all reasonable steps to cause its private fund clients to undergo an audit that would satisfy the proposed rule, so long as the adviser does not control the private fund and is neither controlled by nor under common control with the fund. In addressing what constitutes "all reasonable steps," the proposal offers the following examples:

> "For example, a sub-adviser that has no affiliation to the general partner of a private fund that did not obtain an audit could document the sub-adviser's efforts by including (or seeking to include) the requirement in its sub-advisory agreement. On the contrary, if the adviser is the primary adviser to the fund, even if it is not the general partner or a related person of the general partner, it would likely not be reasonable for the fund not to be audited in accordance with the rule."

NRS believes that the latter example places undue burden on an adviser to a fund where the adviser is not the general partner or a related person of the general partner. If the unaffiliated fund being managed by the adviser chooses not to have a financial audit under the proposed Audit Rule, in the example provided, the adviser would not be able to accept the engagement to manage the fund because it may not be able to meet the reasonableness standard presented. The reasonable standard should be based on an adviser's influence or control over the fund it is advising. NRS believes that "all reasonable steps" afforded sub-advisers should also be adopted for primary advisers under the same circumstances.

Section II. E. Preferential Treatment

Question? *Are there certain investors who require different liquidity terms (e.g., ERISA plans, government plans)? If so, which types of investors and what liquidity terms do they require? How do advisers currently accommodate such investors without disadvantaging other investors in the private fund? Should the proposed rule permit different liquidity terms for these investor types? If so, should the proposed rule impose restrictions in order to protect other private fund investors? If so, which types of restrictions?*

NRS Response: NRS believes that preferential liquidity terms serve as an important facilitator of capital formation and an important factor in the overall risk-reward calculus of many private fund investors. A private fund adviser's inability to offer such terms to certain investors may discourage investment altogether or reduce the level of capital an investor is willing to contribute. Conversely, investors with more aggressive risk profiles may not be able to achieve enhanced performance results that may come as a result of a private fund adviser's ability to offer differentiated terms to various investor types. Some investors may be willing to accept the trade-off for less advantageous investment terms in exchange for higher targeted returns or other concessions and/or opportunities. Consequently, NRS believes that a disclosure-based approach is preferable to an outright prohibition on preferential liquidity terms. We believe that if the existence and potential risks of such terms are clearly disclosed to prospective investors, market forces will encourage the optimal level of risk taking and capital formation. The Commission may consider prescribing a standardized disclosure form and/or content, which is distributed to prospective investors as part of the offering document package. For example, the Commission might require that this disclosure not only set forth, in general terms, the preferential terms entered into with some, but not all, investors, but also as appropriate, how this practice creates a conflict of interest among investors and/or how the practice of negotiating preferential terms with some investors may impact the investment of others in the fund.

Alternatively, if the Commission decides to proceed with the prohibition on different liquidity terms, NRS believes that such prohibitions should be limited to funds relying on the 3(c)(1) exemption from registration under the Investment Company Act and not extended to funds relying on the 3(c)(7) exemption from registration under the Investment Company Act. As suggested in our other responses, this approach will have the effect of providing greater flexibility to investors who do not require additional protections.

NRS believes that the Commission's proposal to prohibit preferential information rights is consistent with the disclosure principles we have advocated in our other responses. We believe that market forces are at their most efficient levels when all participants are in possession of the same information. Therefore, NRS agrees with the Commission's proposal to prohibit preferential information rights.

Section III. Discussion of Proposed Written Documentation of All Advisers' Annual Reviews of Compliance Programs

Questions: *Should we expressly require advisers to document the annual review of their compliance policies and procedures in writing, as proposed? If not, why?*

Should we specify certain elements that must be included in the written documentation of the annual review? For example, should we require the written documentation to address matters similar to those that are required in the chief compliance officer's written report to a registered fund's board of directors pursuant to rule 38a-1 under the Investment Company Act?

NRS Response: NRS supports the Commission's proposal to require that all advisers registered with the Commission document the annual review of their compliance policies and procedures in writing. NRS believes that documenting the results and recommendations of a firm's annual review helps to facilitate the firm's response and remediation of any shortcomings or failures revealed within the program and permits a methodical approach to addressing them. NRS agrees with the Commission, therefore, that written documentation of the annual review can help to promote accountability and a culture of compliance. NRS further believes that documenting the process undertaken to complete the annual review provides transparency into the firm's methodology for assessing the adequacy and effectiveness of policies and procedures and permits evaluation of the review approach and its thoroughness or lack thereof.

It has been the experience of NRS that most SEC registered investment advisers regularly document their annual reviews, though the format, scope, and detail provided in this documentation varies widely from firm to firm. While NRS prizes flexibility in any approach adopted by the Commission, we, nevertheless, suggest that the Commission provide guidance to advisers with respect to the content expected to be included in any written documentation of a firm's annual review, as appropriate. For example, without necessarily requiring a particular approach, format, outline or content, the Commission may, nevertheless, suggest that firms consider, as appropriate and as applicable, including the following or similar content in any annual review report or documentation:

1. A summary of the process undertaken to test and assess the adequacy and effectiveness of the firm's policies and procedures with appropriate references to any separate supporting documentation or testing results;

2. Consideration of new conflicts of interest, requirements or risks arising from changes to the firm's services, compensation arrangements, affiliations, critical service providers or applicable laws, rules, or regulations over the review period;
3. A summary of any gaps or deficiencies uncovered within the firm's policies and procedures, or disclosures, and;
4. Recommendations for adopting new or amending existing policies, procedures, and/or disclosures, or for retraining staff.

The Commission might also suggest that annual review documentation be provided to, reviewed by, and signed off on by one or more members of the firm's senior executive team.

NRS has found that a common concern among investment advisers in documenting an annual review is that too much detail will result in a "roadmap" for examiners by emphasizing issues or potential issues that may not have been revealed by an examination and which, nevertheless, will result in detrimental ramifications for the firm due to its own efforts to detect and correct shortcomings. NRS believes that this concern is widespread within the industry. It also appears to be well founded. As the Commission has noted in the proposal, one purpose of proposing that advisers document their annual reviews is to allow examiners "…to understand an adviser's compliance program, determine whether the adviser is complying with the rule, and identify potential weaknesses in the compliance program."

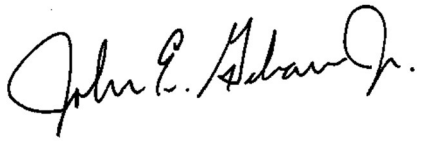
NRS believes that this widespread and strongly held belief sometimes generates corresponding pressures to "water down," generalize, or simplify the descriptive content of annual review documentation. These pressures may even result in the marginalization of CCOs at some firms and exclusion from critical committee or business meetings for fear of creating an annual review finding. Providing a suggested outline and/or content and standards for annual review documentation would go a long way toward countering these pressures. However, NRS further recommends that the Commission consider providing nonbinding reassurances that deficiencies identified by an adviser, summarized in the adviser's annual review documentation, and for which the firm has, at minimum, a written plan for remediation and/or has taken material steps toward remediation, will, generally, be treated with more deference or leniency by examiners than deficiencies that are identified by Commission Staff during an examination but were not detected by the adviser nor recorded in the adviser's annual review documentation. While fully recognizing that fraud and material compliance failures will, nevertheless, result in appropriate action being undertaken by the Commission, such an approach has the benefit of incentivizing firms to be thorough in conducting and documenting their annual reviews and diligent in

promptly addressing deficiencies or shortcomings revealed. Moreover, this approach has precedence in the analogous approach of the Commission exercising forbearance or reduced penalties imposed on firms that self-report regulatory issues. (See, e.g., *Share Class Selection Disclosures Initiative*[2] [wherein the Commission's Division of Enforcement recommended that the Commission accept favorable settlement terms for investment advisers that self-reported possible securities law violations]).

Conclusion

Thank you for the opportunity to comment on the Proposal. We appreciate your consideration of our comments and would be happy to provide any additional information that may help in your endeavor to address these extremely important topics.

Respectfully,



John Gebauer

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[2] https://www.sec.gov/enforce/announcement/scsd-initiative.