



22 West Washington Street
Chicago
Illinois 60602

Telephone: +1 312 696-6000
Facsimile: +1 312 696-6001

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

RE: Release Nos. IA-5955; File No. S7-03-22, RIN 3235-AN07

Proposed Rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

Ladies and Gentlemen:

Morningstar welcomes the opportunity to comment on the recent Securities and Exchange Commission, SEC or Commission, Proposed Rule on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, or Proposed Rule.¹ Morningstar has a long history of advocating for transparency in global markets and brings several unique perspectives to the Proposed Rule. Specifically, through our PitchBook subsidiary, we track data on nearly 14,000 private equity funds, along with other private funds and investment opportunities, spanning venture capital, real estate, private debt, hedge funds, and mergers and acquisitions. Morningstar's mission is to empower investor success. Because we offer an extensive line of products for individual investors, professional financial advisers, and institutional clients, we have a broad view on the Proposed Rule and the potential effects of the disclosures that private fund advisers would provide to their investors if finalized.

Given the Commission's recent loosening of the definition of accredited investor,² Morningstar believes that the Proposed Rule is highly relevant and necessary. As more traditionally retail investors will be swept under the SEC's revised definition of accredited investor in the coming years, Morningstar believes that it is more important now than ever to increase the transparency and ease for investors to understand fund fees, expenses, adviser compensation, and performance. At Morningstar's request, the Employee Benefits Research Institute, or EBRI, provided additional analysis of how rapidly the U.S. retirement system will begin to produce accredited investors as it matures. Using a microsimulation model, EBRI recently examined current retirement accounts in the United States and concluded that just among people with retirement accounts today, 8.8% will have over \$1 million in 10 years and 21.8% will have over \$1 million in 20 years, making more than one in five Americans with a

¹ SEC. 2022. "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews." <https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf> (Proposed Rule).

² Forbes. Aug. 27, 2020. "SEC Rule Change Gives More People Access to Riskier Investments." <https://www.forbes.com/sites/advisor/2020/08/27/sec-definition-change-accredited-investor/?sh=5f5c3e691543>.

retirement account today an accredited investor, and therefore making them eligible to invest in private funds.³

Executive Summary

Morningstar appreciates and agrees with the Commission's intention to enhance reporting, operating, and compliance requirements for private fund advisers. To facilitate the Commission's goal, we suggest the following:

- We recommend that the Commission provide template formats for the proposed quarterly disclosures of private fund fees, expenses, manager compensation, and performance, so that such disclosures are standardized and easily comparable across funds.
- We suggest that the Commission define a third category of funds outside of just liquid and illiquid funds for the purposes of reporting fund performance, and that this new category of funds is required to report a blend of what the SEC proposes to require liquid and illiquid funds to report in order to mitigate reporting problems for advisers of hybrid funds or certain hedge funds.
- We agree with the proposal of prohibiting certain activities that are contrary to the public interest and that benefit private fund advisers to the detriment of the fund and its investors, such as advisers charging fees for unperformed services or funds limiting liability for adviser misconduct.

I. We agree with the SEC's proposal to require private fund advisers to file quarterly disclosures detailing fees and expenses and manager compensation.

a. Fees and Expenses

Morningstar appreciates the Commission's objective to protect private fund investors by promoting more efficiency and transparency from fund advisers.⁴ We think that the SEC's proposal for fund advisers to provide quarterly statements in clear table formats that disclose detailed accounts of fees and expenses generated at the fund and portfolio investment levels will greatly benefit investors. Further, we think the SEC should define a template table format so that fund data is provided in a standardized manner. Fee and expense information presented in an easily accessible format will allow investors to monitor fund fees and expenses more efficiently. This information could significantly help investors evaluate the value of services provided by the adviser and other service providers to the fund.⁵ Currently, private funds provide fee information in a variety of different ways without any uniform standard of listing management or incentive fees. As a result, investors cannot easily compare terms across funds, hindering effective competition in the sector.

There are many different practices for calculating management and incentive fees across funds, which makes for financial results in fund reports that are much more complex and nuanced than

³ This simulation uses standard assumptions and includes participants aged 26-64. The assumptions assume an increasingly conservative asset allocation over time, stochastic rates of return based on Ibbotson/Morningstar data, and inflation expectations from the Social Security Trustees annual reports, among other parameters.

⁴ Proposed Rule, P. 16886.

⁵ Proposed Rule, P. 16944.

necessary.⁶ Many limited partners must do their own accounting, often in distinctive formats, and almost all fund managers offer different data points and terminologies for the calculations that go into determining fees and expenses. Morningstar would like to see the Commission require a standard form of accounting across all funds in order to generate a consistent, undeviating method of reporting fees and expenses. We recommend that the Commission provide a standardized template table for all private funds to which to adhere when reporting fees and expenses. For example, Institutional Limited Partners Association, or ILPA, has advised best practices for fee reporting,⁷ and a standard disclosure could be established based on ILPA best practices to create a fee table that investors become accustomed to reviewing, similar to how mutual fund investors can view expense ratios and other fees in standard formats. Although Morningstar recommends that the Commission provide a template table in its final rule, we do believe that the SEC's proposal for funds to provide a detailed accounting of fees is a step in the right direction that will provide transparency and mitigate confusion amongst investors given the many ways that funds can illustrate fees.

b. Adviser Compensation

Morningstar further supports the SEC's proposal to disclose all adviser compensation during a reporting period. We believe that disclosures of adviser compensation as separate line items will allow investors to easily view the various forms of adviser compensation across the private funds industry and help validate that adviser compensation conforms to contractual agreements. Additionally, we agree with the Commission's extension of the proposed adviser compensation rule to advisers' "related persons," which will further increase transparency for investors.

c. Offsets, Rebates, and Waivers

Morningstar supports the Commission's proposal to require disclosures of fund fees and expenses and adviser compensation both before and after the application of any offsets, rebates, or waivers.⁸ There are many circumstances in which an adviser may offset, rebate, or waive adviser compensation or fund expenses, so complete transparency into these practices is essential for investors to monitor their investments. Furthermore, this proposal may ease investors' efforts in complying with reporting obligations, and it will be helpful for investors to monitor whether and how offsets, rebates, and waivers are applied to reduce their fees.

II. We commend and agree with the Commission's proposal to require private fund advisers to file quarterly disclosures detailing fund performance.

a. Performance

Morningstar agrees with the Commission's proposal for advisers to include standardized fund performance information in each quarterly statement provided to fund investors.⁹ Currently, investors cannot compare private fund returns except on aggregate through reports that we provide through our PitchBook subsidiary that show public firm private equity performance by

⁶ PitchBook. Sept. 10, 2020. "The Fine Print: Unraveling Fund Fees and Terms." https://files.pitchbook.com/website/files/pdf/PitchBook_Q3_2020_Analyst_Note_The_Fine_Print_Unraveling_Fund_Fees_and_Terms.pdf#page=1.

⁷ Institutional Limited Partners Association. "ILPA Reporting Template (XLSX)." <https://go.ilpa.org/RTE>. See accompanying explanation in "ILPA Reporting Template Guidance (PDF)." <https://go.ilpa.org/RTGP>.

⁸ Proposed Rule, P. 16893-16894.

⁹ Proposed Rule, P. 16946.

quarter.¹⁰ On a troubling note, in the SEC’s recent Division of Examinations Risk Alert, it was discovered that some private fund advisers used inaccurate underlying data in performance calculations.¹¹ The Risk Alert also found that private fund advisers provided inaccurate or misleading disclosures about their track record, which may have led astray many investors. We believe that requiring quarterly performance statements will help investors in monitoring and comparing their fund’s performance as well as updating their choices between different funds. The quarterly statements may also lead advisers to report performance data more accurately.

Morningstar suggests that the SEC provide standardized template performance disclosures for private funds to follow depending on the different categorizations of funds, in order to promote accurate reporting of performance data and to allow for comparability of performance across funds. For example, the methodology for performance computations could be based on the Chartered Financial Analyst Institute’s Global Investment Performance Standards, which provides best practices for valuing private fund portfolios.¹² Performance should have to be reported to investors in an individualized way accounting for their specific investment in the fund, as various times of investment yield different performance based on different terms for distinct investors.

Interest in including alternative assets, including private funds, in 401(k) plans has increased¹³ and is permitted, though not encouraged, under Department of Labor, or DOL, guidance.¹⁴ Retail platforms, such as Yieldstreet and Moonfare, have also brought alternatives to nonaccredited investors. We believe that the growing accessibility of alternatives increases the need for complete and accurate performance data to allow comparability and further the Commission’s mission of facilitating competition.

b. Liquid v. Illiquid Fund Determination

We agree with the Commission’s decision to separate liquid and illiquid funds, and we believe that in distinguishing between liquid and illiquid funds, the proposed rule may allow investors to better understand the presentation of a fund’s performance. Morningstar also appreciates that both liquid and illiquid funds will have to report performance since inception, as it is essential that the internal rates of return for private funds are viewed from the start date. That said, we suggest that liquid funds should be required to present average annual net returns over the one-, three-, five-, and 10-year periods. We believe that adding the three-year period will benefit investors looking to view net returns over an intermediate time horizon and will not greatly encumber fund advisers.

Additionally, we worry that the SEC’s binary categorization of funds as either liquid or illiquid could cause problems for advisers of hybrid funds or certain hedge funds. Therefore, we propose

¹⁰ PitchBook. March 1, 2022. “Analysis of Public US PE Firm Earnings: Q4 2021.” Other private equity performance reports can be found on the PitchBook website. <https://pitchbook.com/news/reports/q1-2022-pitchbook-analyst-note-analysis-of-public-us-pe-firm-earnings-q4-2021>.

¹¹ SEC Risk Alert: Division of Examinations. Jan. 27, 2022. “Observations from Examinations of Private Fund Advisers.” <https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf>.

¹² CFA Institute. 2020. “Global Investment Performance Standards (GIPS) For Firms.” https://www.gipsstandards.org/wp-content/uploads/2021/03/2020_gips_standards_firms.pdf.

¹³ Market Watch. Aug. 23, 2021. “Opinion: Why Alternative Investments Belong in 401(k) Plans.” <https://www.marketwatch.com/story/why-alternative-investments-belong-in-401-k-plans-11629471192>.

¹⁴ DOL. Dec. 21, 2021. “U.S. Department of Labor Supplemental Statement on Private Equity in Defined Contribution Plan Designated Investment Alternatives.” <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020-supplemental-statement>; *see also* DOL. June 3, 2020. “U.S. Department of Labor Information Letter.” <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020>.

that the Commission define a third category for hybrid and other funds that do not fit into the classifications of liquid or illiquid funds. We believe that this new category of funds should be required to report a blend of what the SEC proposes to require liquid and illiquid funds to display in their quarterly statements. Moreover, because the Proposed Rule defines a liquid fund as “any private fund that is not an illiquid fund,” defining a third category for hybrid funds would also require the Commission to create a revised, more specific definition of liquid funds.

III. We approve of the Commission’s proposed list of prohibited practices that are contrary to the public interest and the protection of investors.

a. Adviser-Led Secondaries

We agree with the SEC’s proposal to prohibit an adviser from completing an adviser-led secondary transaction with respect to any private fund unless the adviser distributes a fairness opinion. We believe that the prohibition of adviser-led secondary transactions will mitigate conflicts of interest for advisers—such as setting and negotiating the transaction terms—and we think that the absence of a fairness opinion in these transactions could hurt the original shareholder.

b. Fees for Unperformed Services and Other Fees and Expenses

We commend the Commission’s proposal to prohibit compensation schemes where advisers charge for services that they do not reasonably expect to provide.¹⁵ Private fund advisers typically receive performance-based compensation for providing advisory services to a fund that unjustly enriches the advisers at the expense of the private fund and its underlying investors. We believe that the prohibition of compensation schemes where advisers charge for services that they ultimately do not expect to provide will prevent the fund and the majority of its investors from bearing the costs of those payments. In the same light, we agree with the proposal to prevent charging private funds with the expenses associated with examinations or investigations of advisers.¹⁶ The act of charging these expenses to the fund inherently goes against the public interest by placing the interests of advisers ahead of those of investors.

c. Limiting Liability for Adviser Misconduct

Another practice that Morningstar believes to be against public policy is allowing private fund advisers to seek reimbursement, indemnification, or exculpation from the private fund for a breach of fiduciary duty, bad faith, or negligence. Therefore, we agree with the SEC’s proposal to prevent private fund agreements that have waiver and indemnification provisions for advisers. We believe that holding advisers personally responsible for breaching standard industry norms of conduct will encourage advisers to comply with those standards of conduct and promote integrity across private funds.

d. Borrowing

We agree with the Commission’s proposal to prohibit advisers from directly or indirectly borrowing money, securities, or other fund assets from a private fund client. When an adviser borrows from a private fund client, that adviser is then on both sides of the transaction, which creates a conflict of interest for that adviser. Only certain investors with specific information or governance rights would be able to negotiate favorable terms of borrowing from an adviser. Morningstar strongly supports the Commission’s goal to promote equality amongst all investors in a private fund.

¹⁵ Proposed Rule, P. 16921-16922.

¹⁶ Proposed Rule, P. 16920.

Conclusion

In summary, we support the Commission's proposal. We would go further in requiring disclosures about fees and performance to be presented in a standardized format so they are easily comparable. We would add a third category of funds to supplement the liquid and illiquid categories for performance reporting and we would add a three-year horizon for reporting performance to the periods the Commission is already proposing to require. We support other aspects of the proposal addressing the prohibition of various behaviors that are contrary to the protection of investors.

We thank the SEC for the opportunity to comment on the Proposed Rule. Should you wish to discuss any of the comments in this letter, please do not hesitate to contact Jasmin Sethi as indicated below:

Jasmin Sethi at jasmin.sethi@morningstar.com or (617) 501-5446.

Sincerely,

Jasmin Sethi
Associate Director of Policy Research
Morningstar, Inc.

Aron Szapiro
Head of Retirement Studies and Public Policy
Morningstar, Inc./Morningstar Investment Management, LLC

Hilary Wiek
Lead Analyst, Fund Strategies & Performance
Pitchbook Data