April 25, 2022

VIA EMAIL
Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090
(by e-mail to
rule-comments@sec.gov)

Re: File No. S7-03-22
Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (IA-5955), 87 Fed. Reg. 16886 (March 24, 2022) (the "Proposing Release")

Dear Ms. Countryman:

The undersigned individuals, academics as well as former Chairs, Commissioners, and employees of the Securities and Exchange Commission ("SEC" or the "Commission"), write to comment on, and express our concerns with, aspects of the rules proposed by the Commission for private fund advisers in the above-referenced release.[1] This letter represents the consensus view of the undersigned, and it is not necessarily true that each of the undersigned endorses each of the positions taken in this letter. Additionally, this letter expresses the views of the individuals as such, and not the views of the institutions with which any of them is or has been associated.

[1] This letter focuses on the expense and indemnification prohibitions of the proposed rules for private fund advisers. That focus should not be read as an endorsement of other aspects of the proposals.

The primary concern we address is that Proposed Rule 211(h)(2)-1 under the Investment Advisers Act of 1940 ("Advisers Act") is broadly inconsistent with Congress's 1996 determination (in response to the Commission's urging at the time) that private fund investors have the means and ability, in a competitive market, to negotiate for themselves the terms and conditions governing their investments in pooled investment vehicles, including terms related to fund governance. That Congressional determination is expressed in Section 3(c)(7) of the Investment Company Act of 1940 ("Investment Company Act" or "ICA"), which exempts certain pooled vehicles, such as private funds, from the rigors and prescriptive policies of the Investment Company Act. But the Commission now proposes, without presenting adequate justification, to use the Advisers Act to subject private funds to a regulatory regime comparable in relevant part to that of the Investment Company Act. In essence and practical effect, the proposed rules would subject private funds to regulation in a form that Congress precluded. As proposed, and contrary to Congressional design, the rules would broadly prohibit a wide range of non-fraudulent, non-deceptive, non-manipulative practices that are common in the industry, without satisfactorily identifying any need for the prohibitions or providing evidence of any related market failure to which the proposed rules are responsive.

Three aspects of the proposed rules are of particular concern and, in our view, exceed the Commission's statutory authority. Those aspects are the prohibitions on the ability of advisers, and investors in their private funds, to agree between themselves, with full and fair disclosure, that:

> (1) the fund itself (rather than the adviser) will be responsible for paying the costs associated with any examination or investigation of the fund, the adviser, or its related persons;
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> (2) the fund itself will similarly be responsible for bearing the regulatory and compliance expenses of the fund, the adviser, or its related persons; and
>
> (3) the fund will reimburse, indemnify or otherwise limit the adviser's liability to the fund or its investors for, among other things, negligence in providing services to the private fund.

The Commission's economic analysis in the Proposing Release also fails adequately to establish, consider, or balance the significant costs and harm to funds, their investors, and their investment advisers that are likely to result if the proposed rules are adopted.

Finally, even if there were established a need to take action to prevent fraud and client abuses in this area—which is not evidenced in the Proposing Release—these proposed rules travel the wrong path. Equally effective measures that are less disruptive, less costly, and well within the Commission's statutory authority are readily available.

1. The SEC's Proposal Exceeds Statutory Authority and is Contrary to Congressional Design.

The Advisers Act was the last in a series of statutes designed to eliminate certain abuses in the securities industry. It was preceded by the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act"), and, most importantly for present purposes, the Investment Company Act. The Investment Company Act sets forth a rigid, proscriptive and highly constraining framework for regulating and governing pooled investment vehicles available to the public at large. That framework necessarily, and intentionally, has the effect of severely limiting the choices available to investors. The Advisers Act, in contrast, adopted as a "sister statute" in the same year as the ICA, addresses the relationship between investment advisers and their clients. As relevant to these proposed rules (where the "clients" are the investment funds themselves, and not the investors in those funds), aspects of the Advisers Act have evolved to provide relatively "hands off" regulation for private funds—pooled investment vehicles that are exempt from the Investment Company Act because they are available only to sufficiently wealthy individuals and large institutions that are considered to be highly sophisticated in financial matters and that typically retain highly sophisticated legal, financial and accounting professionals.[2]

The SEC is proposing to upend this longstanding Congressionally mandated legal and regulatory regime by adopting a reporting and governance framework for "private funds," a term used to describe investment vehicles that are excluded by Congress from the Investment Company Act's framework governing registered pooled investment vehicles. Specifically, Rule 211(h)(2)-1 would, among other things, prohibit advisers to private funds from agreeing with their private fund investors (after full and fair disclosure) that the private fund itself would bear fees and expenses associated with examinations or investigations by any governmental or regulatory authority. Proposed Rule 211(h)(2)-1 also would preclude advisers to private funds from agreeing with their private fund investors (after full and fair disclosure) that the private fund itself would bear the normal expenses of regulatory compliance. Finally, the same proposed rule would prevent advisers from seeking reimbursement, indemnification, exculpation, or limitation of the adviser's liability by the private fund or its investors for negligence in providing services to the private fund.[3] The Proposing Release identifies the SEC's general anti-fraud and rulemaking authority in Section 206(4) of the Advisers Act, as well as the specific authorization of Section 211(h) of the Advisers Act, as the authority for the proposed rule. Notably, Section 211(h) directs the SEC to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with…investment advisers." But rather than facilitate simple and clear disclosures, the proposed rules constitute total abandonment of the SEC's traditional disclosure framework and

[2] ICA §3(c)(1) also exempts from the Investment Company Act smaller funds whose investors meet lower standards of wealth and sophistication, and the "private funds" to which the proposed rules are addressed are defined in Advisers Act §2(a)(29) to include both 3(c)(1) and 3(c)(7) funds. However, the vast majority of the assets under management of the private funds to which the proposed rules are directed are held in 3(c)(7) funds, described below. The discussion in the text therefore focuses entirely on 3(c)(7) funds. If the proposed rules were limited in their application to advisers of 3(c)(1) funds, our concerns would be lesser in degree, but not in kind.

[3] The rule would also bar reimbursement, etc." for a breach of fiduciary duty, willful misfeasance, bad faith . . . or recklessness," but fund agreements do not generally provide for indemnification in those circumstances, and, if sought, we expect indemnification would routinely be denied by the courts.

propose an entirely new regulatory regime governing private funds in which, inconsistent with statutory text, legislative intent, and prior Commission positions, provisions that are disfavored by the Commission would be prohibited even if sophisticated, fully informed, and well represented investors are ready to accept them.

a. The Proposed Rule Undermines Congressional Intent to Exclude Private Funds from Regulation as Investment Companies

The SEC's proposed rules run afoul of the well-established principle of U.S. law that sister statutes should be read harmoniously.[4] Indeed, the proposed rules conflict directly with the text and clear purpose of the Investment Company Act, the statute specifically designed to regulate pooled investment vehicles. Congress excluded private funds from the SEC's regulatory authority in 1996 by adding Section 3(c)(7) that exempts certain pooled investment vehicles from the Investment Company Act. As noted above, the vast majority of private funds to which the proposed rules are addressed are such exempt "3(c)(7)" funds. Investors in these funds must be "qualified purchasers"[5]—institutions or wealthy individuals who are highly sophisticated in financial matters or who hire legal and financial advisers with those qualifications. Moreover, in the selection of funds in which they might invest, there are some 5,000 registered managers vying for their business.[6] This is a market in which investors of means, with a very high degree of sophistication, are readily able to negotiate for the terms that are important to them.

Adopting the proposed rules would therefore be entirely inconsistent with Congress's determination to exempt such funds from the proscriptive rigors of the Investment Company Act. The Commission lacks statutory authority, through rulemaking, to undo this Congressional design. Moreover, the proposed rules reflect an attempt to use the Advisers Act's general anti-fraud authority as a backdoor means of imposing restrictions on private funds, even though the Commission does not, in the Proposing Release, and cannot, demonstrate any realistic way in which the prohibited activities are fraudulent or open the door to fraud, particularly in light of its concession that the challenged practices are fully disclosed to investors.

The Investment Company Act establishes a comprehensive regulatory framework for regulating pooled investment vehicles that are open to the public, replete with reporting and disclosure requirements, restrictions on expenses that may be charged to investors by funds, restrictions on fund investments and fund capital structure, prohibitions against affiliate self-dealing, and prescriptive contractual and governance requirements. Congress purposely excluded private funds formed under Section 3(c)(7) of the Investment Company Act from regulation as investment companies because it determined that such regulation was unwarranted—unnecessary from the perspective of the investors, and unwarranted as an expenditure of public funds and energy. Sections 206 and 211 of the Advisers Act cannot properly be used as a workaround by

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[4] *See* Scalia & Garner, *Reading Law: The Interpretation of Legal Texts* (2012).

[5] Generally, a qualified purchaser includes a natural person who owns not less than $5,000,000 in investments or any other person acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests not less than $25 million in investments. 15 USC § 80a-2(a)(51).

[6] Proposing Release at 16935.

the Commission to regulate funds that have been expressly excluded from such regulation by Congress. Put another way, the Commission cannot use its claimed Advisers' Act authority to contravene Congressional determinations embodied in the Investment Company Act.

The legislative history of Section 3(c)(7) is revealing. In 1996, during the Clinton administration, Congress passed the National Securities Markets Improvement Act ("NSMIA") which added new Section 3(c)(7), referred to above, to the Investment Company Act. Congress adopted this new exception based in large part upon the recommendation of the Staff of the SEC's Division of Investment Management, which had determined that "the new exception would be premised on the theory that 'qualified purchasers' do not need the [ICA's] protections *because they are able to monitor for themselves such matters as management fees, transactions with affiliates, corporate governance, and leverage.*"[7] The Staff further concluded that "no sufficiently useful governmental purpose is served by continuing to regulate funds owned exclusively by sophisticated investors."[8] The Section 3(c)(7) exclusion thus reflects a Congressional determination that financially sophisticated investors are capable of appreciating the risks associated with certain investment pools, that they do not need the protections of the ICA,[9] and that the government's regulatory apparatus is better directed elsewhere.

Qualified purchasers are sophisticated market participants capable of investing their money as they wish and tailoring their own relationships with private funds and those funds' investment advisers. As noted, the qualified purchaser standard applicable to investors in Section 3(c)(7) funds is high, and indeed, is much more stringent than the "accredited investor" standard under the Securities Act of 1933.[10] In adopting rules further implementing the provisions of NSMIA regarding qualified purchasers, the SEC acknowledged that Congress intended this exclusion for persons with "investment experience and sophistication necessary to evaluate the risks of investing in unregulated investment pools."[11]

The SEC's proposed rule and the SEC's supporting rationale now suggest the exact opposite. With no supporting evidence, the Commission asserts as *ipse dixit* that sophisticated investors are unable to evaluate the risks of investing in pools without the SEC prescribing the contractual terms pursuant to which these sophisticated investors and their advisors may invest. The SEC provides no satisfactory explanation for this drastic change in policy. Given the legislative history and statutory provisions regarding these funds, the SEC exceeds its statutory

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7 Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, U.S. Securities and Exchange Commission (May 1992) at 104-5 (emphasis added).

8 *Id*. at 114-115.

9 *Id*. at 115.

10 Specifically, as noted above, Section 2(a)(51) of the ICA defines a qualified purchaser as a natural person or company who owns $5 million or more *in investments* as that term is defined in Rule 2a51 under the ICA. In contrast, a natural person is an "accredited investor" under Rule 501 if their *total net worth* exceeds $1,000,000 (exclusive of the value of the person's primary residence).

11 *Privately Offered Investment Companies*, Inv. Co. Act Rel. No. 22597 (Apr. 3, 1997), 62 Fed. Reg. 17512 (Apr. 9, 1997)..

authority when it invokes the administrative process to reach a result so dramatically at odds with statutory text, legislative intent, and historic Commission positions upon which Congress relied.

2. The SEC Fails to Provide Quantifiable Justification for the Proposed Rules Relative to the Tremendous Costs They Would Impose if Adopted

The Proposing Release provides virtually no justification for the proposed rules, all of which, if adopted, would constitute drastic shifts in relevant regulatory policy. The proposal merely states "private fund investments can be opaque" and observes that "investors lack sufficiently detailed information about fund fees and expenses and the preferred terms granted to certain investors and often lack sufficient transparency into how private fund performance is calculated."[12] With regard to limitations of liability in private fund contracts, the Commission's economic analysis simply notes "[t]hese practices, even when disclosed and permissible under state law, *may* involve breaches of fiduciary duty to the fund or investors, and possible harms to investors, and so investors *will likely* benefit from their prohibition."[13] (Emphasis added). These conclusions, however, are entirely speculative and subjective. They merely substitute the SEC's own judgments for those of extremely sophisticated, fully informed, and well-represented private fund investors, who are already capable of protecting their own interests. The SEC provides no credible reasons (or any evidence) for concluding, contrary to the clear Congressional view (as well as experience and logic), that sophisticated investors are unable to fend for themselves when investing in private funds, or that they would prefer the regulatory regime that the agency now seeks to impose in clear contravention of the statutory design.

As noted, the private fund industry is extremely competitive. The Proposing Release identifies more than 5,000 registered investment advisers with private fund clients.[14] This figure does not include private funds managed by exempt reporting advisers or advisers that are not eligible for SEC registration. Investors are free to choose the terms they are willing to accept, including cost and liability allocation provisions, when investing in a private fund. As stated above, private fund investors are sophisticated parties that Congress determined do not require government or SEC control over the terms of their private investment agreements. These investors are also free to invest in the vast array of registered investment companies if they wish to have such protections, and those alternatives have lower fees and greater liquidity. The SEC has not demonstrated that the proposed rule is necessary or in the public interest, or that it justifies the costs of interfering with private fund arrangements.

The Administrative Procedure Act ("APA") requires that the SEC build a comprehensive and rigorous record and that it assess the significant costs of proposed regulation. Under the APA, the SEC has a foundational duty of reasoned decision-making in administrative proceedings. In order to conduct a proper rulemaking, the SEC needs to "examine the relevant data"— including quantitative and qualitative evidence submitted — "and articulate a satisfactory explanation for its

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12 Proposing Release at 16492.

13 *Id.* At 16950-51..

14 *Id.* at 16,935

action including a 'rational connection between the facts found and the choices made.'"[15] This core APA requirement includes an obligation to "consider … important aspect[s] of the problem" before the agency.[16]

The proposed rule fails this standard. In many ways, it identifies a solution in search of a problem. The SEC's analysis identifies no firm basis for the proposed rules, nor does it provide firm evidence of any sort of widespread problem, involving either private fund investors or private fund advisers. Instead, the proposal is replete with conclusory, unsubstantiated statements regarding private fund advisory agreements. The Proposing Release cites only 24 cases over 17 years—an astonishingly low number for an industry with over 5,000 active managers. Moreover, while those cases are identified as evidence of improper behavior, 22 of them were settled matters, and neither we, nor the Commission, can determine from a settled matter whether there was any underlying improper behavior or, if there was, whether it was material in the circumstances. In these settled cases, the respondents neither admit nor deny the violation. But the Commission now asks the world to ignore those important aspects of the central provisions of each settlement agreement, and to assume that a material violation occurred in each settled matter.[17] Even accepting such an unwarranted assumption, it is noteworthy that the aggregate of remedial recoveries and sanctions imposed in all 22 of the settled cases, brought over a 17-year period, is only $96 million. That is a trivial amount in the context of an industry with assets under management of over $18 Trillion[18] It is absurd to add significant costs to an industry that has shown over time to have had remarkably few problems.

With regard to the rule's proposed prohibited activities and disclosure of preferential treatment, the SEC prefaces its analysis with a general disclaimer that quantifying the economic effects of these proposals is difficult because "there is a lack of data on the extent to which advisers engage in certain of the activities that would be prohibited under the proposed rules, *as well as their significance to the business of such advisers*."[19] This same language of the Proposing Release goes on to concede that it is difficult to determine "… how advisers may change their behavior in response to these prohibitions."[20] It may be that there is a lack of data. It may be that it is difficult to determine what responses would follow from adopting the rules. But those are precisely the determinations that the SEC is required to make in the rulemaking process. It may be that a

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[15] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

[16] *Id.*

[17] It should also be noted that at least two of the cited settlements involved allegations of conduct that is not addressed by the proposed rules and would not be prevented by them. *See In the Matter of Och-Ziff Capital Management Group, LLC*, Investment Advisers Act Release No. 4540 (Sept. 29, 2016) (alleging violations of the Foreign Corrupt Practices Act); *In the Matter of Bluecrest Capital Management Limited*, Investment Advisers Act Release No. 5642 (Dec. 8, 2020) (alleging a fraud in which fund managers transferred their best traders to a proprietary fund).

[18] Proposing Release at 16887.

[19] Proposing Release at 16948 *(emphasis added)*

[20] *Id.*

principal reason for the lack of data is that there is no problem to which the rules would be legitimately responsive.

It is unclear why the SEC would resort to rulemaking of this significance —in particular, proposing the *prohibition* of certain widespread practices involving sophisticated investors in a competitive marketplace when more reasonable alternatives are available—without more information regarding the extent to which advisers engage in these practices as well as the significance of each of these practices to the business of such advisers, or an understanding of how advisers will likely change their behavior in response to the rules, if adopted.

Even the SEC's qualitative analysis of the costs of its proposed prohibitions, however, recognizes the concerns regarding the potential for increased costs for investors, advisers, and others. For example, the SEC states that the proposal to prohibit a private fund adviser from charging the fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, or for the regulatory and compliance fees and expenses of the adviser or its related persons, may increase costs to investors as a result of increased substitute charges, such as increased management fees, and the potential for lower returns and/or the cost of avoiding such reductions in returns.[21] But this recognition is presented without the parallel recognition that allocating these risks to the fund may be economically efficient because of diversification considerations. More fundamentally, the Commission fails to recognize that sophisticated investors could, if they preferred, negotiate today to pay higher fees in return for contractual provisions that the Commission now proposes to make mandatory. The fact that these sophisticated investors do not bargain for that outcome – because there is certainly a fee at which advisers would accept the Commission's proposed constraints – demonstrates that sophisticated investors prefer the observed status quo to the suboptimal arrangement that the Commission seeks to impose on the market for advisory services provided to the most sophisticated of investors.

Similarly, the SEC notes that the proposal to prohibit an adviser to a private fund, directly or indirectly, from seeking indemnification by the private fund for negligence in providing services to the private fund may result in increased management fees or increase other alternative permissible sources of compensation for these expenses from the fund.[22] Such a significant proposed change in policy should be supported by real, identifiable, investor harm; and should be weighed against the potential costs to investors and advisers, as well as the impact on the capital markets more broadly. And, again, if sophisticated investors thought it advisable to negotiate investment agreements that comply with this proposed restriction, they are fully capable of doing so without the Commission's regulatory intervention. The fact that they do not negotiate for those provisions again indicates that they are suboptimal, and that the Commission is seeking to impose suboptimal constraints on a market involving the most sophisticated of investors, and all in contravention of statutory design.

[21] Proposing Release at 16949.

[22] *Id.* At 16951.

3. If Any Action is Thought Important and Necessary, the SEC Should Re-Propose Less Prescriptive Alternatives

The SEC seeks to rely on Section 206(4) of the Advisers Act to impose broad prohibitions on common industry practices and agreements, including prohibiting advisers from charging expenses associated with an examination or investigation to the fund itself and, indirectly, to its investors. We acknowledge, of course, that Section 206(4) permits the SEC to adopt prophylactic rules that may prohibit acts that are not themselves fraud, but the prohibition must be "reasonably designed to prevent…acts and practices [that] are fraudulent."[23] The proposed rules, however, fail that standard and prohibit a wide range of activities that plainly are not fraudulent, and are not of such a nature that they could lead to fraud.

a. The Proposed Rule Is Not Reasonably Designed to Prevent Fraud

None of the prohibitions discussed in this comment letter is of such a nature that it would somehow be improper to leave in place the agreements that have heretofore been reached between advisers and fund investors, or to permit future investors to reach comparable agreements..

With regard to the expenses of examinations and investigations, they are generally routine aspects of the business of an investment adviser. The Commission has an entire separate division, the Division of Examinations, devoted to examining regulated entities simply to determine whether there are practices of interest to the Commission. What could possibly be fraudulent, or suggestive of fraud, when advisers and investors agree that such routine operating expenses may be paid by the fund? Equally important, when and if the Commission Staff determines that, in its view, inappropriate actions were taken by the adviser, the SEC can insist as a condition of any settlement that the expenses not be charged to the fund. The SEC has routinely used such provisions in comparable situations in settlements in the past, and could do so here.[24] In the very

[23] The Supreme Court, in *United States v. O'Hagan*, interpreted nearly identical language in Section 14(e) of the Securities Exchange Act as providing the Commission with authority to adopt rules that are "definitional and prophylactic" and that may prohibit acts that are "not themselves fraudulent ... if the prohibition is 'reasonably designed to prevent ... acts and practices [that] are fraudulent.'" *See United States v. O'Hagan*, 521 U.S. 642, at 667, 673 (1997); *see also Political Contributions by Certain Investment Advisers*, Inv. Adv. Act Rel. No. 2910 (Aug. 3, 2009) (discussing *O'Hagan* and the Commission's authority to adopt prophylactic rules that prohibit non-fraudulent activities under the Advisers Act).

[24] See, e.g., *In the Matter of Sands Brothers Asset Management, et al.,* Inv. Adv Act Rel. No. 4273 (Nov. 19, 2015) (requiring compensation and expenses of an Independent Monitor be borne exclusively by investment adviser and without direct or indirect reimbursement from any of the funds). Similarly, the Commission has commonly required defendants not to seek or accept, directly or indirectly, reimbursement or indemnification from any source with regard to any civil penalty amounts paid pursuant to a judgment, *see, e.g., In the Matter of Edward D. Jones & Co.*, Securities Act Rel. No. 8520A (July 13, 2007).

rare case that goes to court, the Commission can equally request that relief from the court.[25] Thus, not only is there no legitimate basis for the rule's prohibition, there is no need for it.

As to compliance expenses more generally, there are two principal objections to the proposed rule. Indeed, both suggest that the proposed rule would be counterproductive *from the Commission's perspective.* First, charging compliance expenses to the fund incentivizes advisers to incur those expenses whenever the benefit exceeds the cost. If the adviser pays the expenses itself, the incentive calculus will be whether the benefit to the adviser (*i.e.,* the portion of the benefit equal to the adviser's profit participation) exceeds the expense that the adviser must bear. Inevitably, this will lead to a lower commitment to compliance when compliance expenses are paid by the adviser rather than being paid by the fund. While some would perhaps argue that from a theoretical economic perspective this might lead to over-spending on compliance in an expense pass-through structure, that would be a strange objection indeed to emanate from the Commission. The Commission should prefer, rather than prohibit, a result in which the adviser's incentive is to spend more on compliance. The Commission thus seems to have this calculus backwards.

Second, it is well-recognized that a firm's control functions, including the compliance department, are the "third line of defense," after the direct business participants and the managers of the particular business. But compelling a distinction between "compliance expenses," borne by the adviser, and other expenses, borne by the fund, will inevitably lead firms to concentrate efforts in the designated compliance department and minimize compliance-related expenses elsewhere in the fund. This suboptimal set of incentives is directly opposed to the Commission's interest in the rational allocation of compliance expenditures.

The question of indemnification is different. The fact of the matter is that throughout corporate America, it is recognized that indemnification of officers and directors (who, like advisers, have a fiduciary duty) is routinely acceptable. The matter has been litigated countless times, and the overwhelming conclusion is that indemnification is permissible and appropriate—including in all other entities within the purview of the Commission. The Delaware General Corporation Law, governing law for the vast majority of publicly held corporations, specifically provides:

> "A corporation shall have power to indemnify any person . . . against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation . . . ."[26]

Pursuant to that authorization, virtually all Delaware corporations have provided for such indemnification. Similar provisions exist in other states. How can such a universally accepted provision now be thought, in the sole instance of the investment adviser, to be fraudulent or in

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[25] See, e.g., *SEC vs. American Growth Funding II, LLC, et al.*, Civ. Action No. 16-828 (S.D.N.Y. Jan. 18, 2019); *SEC v. Stifel,Nicolaus & Company, Incorporated, et al.*, Case No. 11-CV-755 (E.D. Wis. Dec. 6, 2017); *SEC vs. Bank of America Corporation,* Civ. Action Nos. 09-6829, 10-0215 (S.D.N.Y. Feb. 4, 2010) (requiring defendants not to seek or accept, directly or indirectly, reimbursement or indemnification from any source with regard to any civil penalty amounts).

[26] Del. Gen. Corp. Law §145.

some manner opening the door to fraud? There is no basis for the Commission to carve out this one industry and decree that indemnification is improper.

b. The SEC's Anti-Fraud Authority Already Prohibits Fraudulent Conduct

There are no benefits to imposing these prescriptive requirements, especially because the SEC already has authority to police fraudulent conduct under the general anti-fraud provisions of the securities laws. The Proposing Release states that the SEC has observed that "certain sales practices, conflicts of interest, and compensation schemes are either not transparent to investors or can be harmful and have significant negative effects on private fund returns." However, the SEC's existing authority under the Securities Act of 1933, Securities Exchange Act of 1934, and Advisers Act permit it to police securities fraud perpetrated by private funds and their sponsors/advisers. All sales and offers of fund shares are subject to Exchange Act Rule 10b-5, which prohibits any misstatement or omission of material information. Further, the fund's investment adviser is a fiduciary and subject to Section 206 of the Advisers Act, which prohibits an investment adviser from defrauding its clients.[27] Indeed, the SEC has invoked Section 206 of the Advisers Act in numerous settled enforcement actions against private fund advisers involving conduct that is essentially identical to that which the Commission now proposes to prohibit.[28]

In contrast to the SEC's proposal, however, these settlements all involved instances where it was alleged (but never established) that an investment adviser was charging clients fees or allocating expenses in a manner that was *not properly disclosed*. In other words, the charge in these cases was that an adviser actually defrauded its clients and the Commission was able to use its existing authority to appropriately address what it perceived as violations. The SEC's current proposal goes far beyond that which is necessary or appropriate to prevent fraud. The new rule attempts broadly to prohibit industry practices that are widely accepted by existing private fund investors and instead imposes substantive regulatory obligations, substituting the SEC's judgment for the judgment of investors who, in Congress's judgment, are capable of evaluating investment terms by themselves. In this context, Congress' judgment must prevail over the Commission's.

c. If the SEC Were to Proceed with Rulemaking Targeting Private Funds, it Should Examine the Industry More Closely and Consider Codifying Disclosure Requirements Rather than Prohibiting Non-Fraudulent Conduct

If, notwithstanding the foregoing, the SEC believes rulemaking in the private fund market is likely warranted, it should do two things.

First, it should take the time to gather data and gain a more clear picture of the private fund industry as it exists today. As described above, the Proposing Release is woefully insufficient in describing any need for current rulemaking in this area, and there is certainly no suggestion that

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[27] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963).

[28] See, e.g., *In the Matter of Lincolnshire Management*, Inv. Adv. Act Rel No. 3927 (Sept. 22, 2014) (settled action for disproportionate allocation of fees and expenses where multiple private funds have invested in the same portfolio investment); *In the Matter of Blackstone Management Partners, et. al.*, Inv. Adv. Act Rel. No. 4219 (Oct. 7, 2015) (settled action for undisclosed accelerated monitoring fees); *SEC v. Westport Capital Markets, LLC and Christopher E. McClure*, Lit. Rel. No. 24007 (Mar. 16, 2020) (civil action for undisclosed fees to adviser and its related persons).

there are current issues that require any immediate response. Information is readily available in this area, and the Commission should take the time to marshal evidence, if such evidence exists, in support of any rulemaking. If, after examining the relevant information, the SEC concludes that some regulatory response is appropriate, it should consider whether it can address its concerns through traditional disclosure mechanisms rather than disruptive prohibitions, particularly in view of the highly sophisticated population to whom these products are offered. This course of action would be consistent with the SEC's statutory authority and the SEC's own prior enforcement actions. It is neither fraudulent nor misleading for an adviser to pass-through to the fund the adviser's fees or expenses associated with a regulatory examination, or more generally related to compliance, provided that the adviser fully discloses the practice and fund investors agree to bear those costs. Similarly, it is neither fraudulent nor misleading for an adviser to a private fund to limit its liability or to seek indemnification in the case of an adviser's ordinary negligence, provided the investors agree.

d. If the SEC Were to Proceed with the Proposed Rules, It Should Permit Pre-Existing Arrangements to Remain in Place

If the SEC were to proceed with the proposed rules, the rules should not apply to existing arrangements between investors and advisers. As stated above, fund agreements are heavily negotiated between investors and advisers. The SEC cannot expect the industry to uproot existing advisory contracts and related agreements after they have taken effect and thereby materially alter the nature of those established, non-fraudulent relationships that have generated significant reliance interests. Without being permitted to continue with existing contracts, fund advisers and fund investors may be unable to agree upon amendments to existing advisory agreements necessary to comply with the rule including, for example, changes in advisory fees in light of the newly imposed obligations on advisers to private funds. This could require investment advisers to liquidate funds to the detriment of both advisers and investors. Depending on then-prevailing circumstances, it could also enable investors to abrogate prior commitments, to the detriment of other continuing investors in the same fund. At the very least, the Commission should ameliorate these difficulties by permitting existing arrangements affecting moneys already invested or committed to continue in place for a very substantial period—we would suggest 10 years—until the markets, managers and investors can fully absorb the effects of the new rules and take appropriate responsive action.

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The undersigned persons appreciate the opportunity to comment on the proposals related to private fund advisers. We would be pleased to answer any questions you may have with respect to our comments.

Very truly yours,

Signatories:

Name (in alphabetical order)	Principal current affiliation (for identification only)[*]	Relevant former government position
Brian Cartwright		SEC General Counsel (2006-08)
Jay Clayton	Sullivan & Cromwell LLP (Sr. Policy Advisor and Of Counsel)	SEC Chairman (2017-21)
Joseph A. Grundfest	Stanford University Law School	SEC Commissioner (1985-90)
Paul G. Mahoney	University of Virginia School of Law	
Harvey L. Pitt	Kalorama Partners	SEC Chairman (2001-03), SEC General Counsel (1975-78)
Adam Pritchard	University of Michigan Law School	
James S. Spindler	The University of Texas at Austin School of Law	
Robert B. Stebbins	Willkie Farr & Gallagher LLP	SEC General Counsel (2017-21)
J.W. Verret	Antonin Scalia Law School, George Mason University	Chief Economist and Senior Counsel, U.S. House Comm. On Financial Services (2013-15)
Charles Whitehead	Cornell University Law School	

[*] This letter represents the consensus of the views of the individual signatories, and it is not necessarily true that every signatory agrees with every statement made. Additionally, the signatories are providing their views as individuals, and those views do not necessarily reflect the views of the institutions with which they are affiliated. Finally, some of the signatories have or may have relationships with firms that would be adversely affected by the Proposed Rules, and may have financial interests in the subject matter. No signatory has been compensated, however, for signing this letter as a signatory or for work in preparing this letter