April 23, 2022

Via Electronic Submission

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

Re: Proposed Rule on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews. File No. S7-03-22

Dear Ms. Countryman:

I appreciate the opportunity to comment on the Security and Exchange Commission's proposed rules governing Private Fund Advisers, File No. S7-03-22 (the "**Proposed Rules**"). Specifically, I am commenting on the section of the Proposed Rules entitled *Prohibited Activities*, which among other things, would forbid investment advisers from charging investors in private funds for the expenses and fees associated with complying with regulations, as well as cost incurred from examinations and investigations. While I applaud the Commission for revisiting regulations to see if they need to be revised in the face of changing market conditions, I am deeply concerned that the proposals, as written, will affect the actions of fund advisers in ways that will result in material adverse consequences for the very investors that the Commission was intending to help. I believe that once the Commission is fully cognizant of the "knock-on" effects of the Proposed Rules regarding charging investors for compliance costs, those rules will be dropped from the proposed list of prohibited activities.

By way of background, for most of my adult life I was an academic economist.[1] My academic research focused on market inefficiencies and the role for government interventions when there is asymmetric information or principal agent problems. In the case of a private fund, the investor (the principal) can't control the actions of the adviser (the agent). My published research in referred journals involved proving theorems showing how unfettered competition can lead to inefficient outcomes. This background has made me more supportive of the role of the Commission in correcting for market failures than might be the case had I taken a different career path.

My academic research on optimal incentives led to the design of the compensation structure of the funds managed by WAM ("**WAM Funds**").[2] While I am supportive of the role of the Commission in overcoming market imperfections, I believe that prohibiting advisers from charging investors for compliance costs will have serious adverse consequences that were not envisioned by the Commission and that are contrary to the intentions of the Commission. I note that this is the first comment letter that I have *ever* written objecting to a proposed regulation by the Commission or any other regulatory agency. I am writing because I feel that the Commission may be

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[1] I was elected a fellow of the Econometric Society in the 1980s, and became an *emeritus* professor of economics at Boston University in the early 2000s. I am also the founder and CEO of Weiss Asset Management LP, a registered investment adviser ("**WAM**"). My research with Joseph Stiglitz on market failures in credit markets was cited by the Nobel Prize committee when awarding him the Nobel Prize in Economics.

[2] See Andrew Weiss, "Would Hedge Fund Investors Benefit From Paying Operating Expenses," *The Journal of Investing,* Spring 2004. Note that my implementation of the expense pass-through does entail the adviser paying some expenses. For instance, the investors do not pay for marketing, rent or compensation to the principals of the adviser; compliance costs are paid by the investors. The allocation of expenses was designed to incentivize the adviser to act in the interest of the investors.

unaware of the likely *responses* of fund advisers and other profit maximizing market participants to the Proposed Rules, and how those responses could lead to outcomes that are the opposite of those the Commission is seeking to achieve. Moreover, I am confident that once the Commission becomes aware of these unintended consequences, proposed regulations that are likely to harm investors will be dropped. I would note that understanding the total effects of various changes in markets is not a trivial undertaking and that investors may misunderstand the ramifications of restrictions on contracts and consequently be supportive of proposals that seem to help them but that upon deeper analysis will harm them. I am also concerned that the Proposed Rules could be destabilizing for the financial system though their effects on the portfolios of private funds.

I have summarized my specific concerns with the Proposed Rules below.

The Proposed Rules Provide a Disincentive for A Private Fund to Enter New Markets and Pursue New Strategies. Those strategies could be profitable to investors if they were paying the compliance costs, but the adviser would be less likely to pursue these strategies because the compliance costs could make them unprofitable to the adviser. As Harvey Pitt showed in his comment letter and as was described in my *Journal of Investing* article, if the increased profit from the new strategy was $1 million, but the increased compliance cost was $300,000, a fund manager who was getting 20% of the profits would not pursue that strategy if it had to pay compliance costs: the adviser would suffer a loss of $100,000 (profit share of $200,000 minus compliance cost of $300,000) if it entered the market. However, if the compliance cost was paid by the investors, the adviser would pursue the strategy, and the investors would have their returns increased by $560,000 (they would receive 80% of profits net of compliance costs or 0.8 x ($1,000,000 - $300,000) = $560,000). This result is not sensitive to the particular percentage of profits taken by the advisor, although the bias is more onerous as the performance fee taken by the advisor becomes smaller.[3]

The disincentive to having a diversified portfolio also increases the risk to a smaller investor who can't diversify across multiple private funds.

The Proposed Rules Provide a Disincentive for A Private Fund to Maintain a Diversified Portfolio. Compliance and regulatory fees and expenses increase with complexity of the investment strategy pursued by an adviser. Complexity increases with the number of securities, strategies, and markets in which a fund invests. Therefore, once the adviser to a private fund has to bear compliance costs, the adviser will have an incentive to gradually exit strategies and markets as a means of reducing compliance costs. Advisers would therefore be incentivized to take actions that are contrary to the interests of the investors (the argument for why investors are harmed is the same as described above). Fund advisers will be incentivized to become more narrowly focused. They will abandon strategies and exit markets whenever the saving in compliance cost outweighs the negative effect of lower risk-adjusted returns on the performance fee of the manager.

The Proposed Rules Provide a Disincentive for A Private Fund to Have Multiple Counterparties. Compliance costs increase with each additional custodian, prime broker, ISDA counterparty and other counterparties that a fund faces. Advisers have duties to due diligence and monitor all their counterparties. During the financial crisis of 2008

[3] Note that even if the adviser was getting more than half the profits there would still be an incentive for the investors to pay compliance costs. When expenses are paid by the investor, those expenses are deducted from the gross profits and the investor gets its share of the net profits. Therefore, the investor's profits increase from that investment being made even if they are only getting a small fraction of the net profits. But an adviser would incur a loss on an investment if *its share* of gross profits was less than the costs of making that investment – including increased compliance costs. This argument holds regardless of the share of profits accruing to the adviser.

when Lehman Brothers failed, it became abundantly evident how having multiple prime brokers, custodians and ISDA counterparties is important to reduce risk to investors. The Proposed Rules incentivize advisers to reduce the number of counterparties they work with, increasing the risk to the fund and its investors. At a macro level, this could result in fewer counterparties serving the industry, which would increase systemic risk in financial markets and make the economy less stable.

The Proposed Rules Provide a Disincentive for A Private Fund to Engage In Complex Hedging Strategies. Hedging strategies can reduce risk to a fund and its investors. A profit-maximizing adviser should seek to implement hedges if they are cost-effective: that is, they should put on hedges when the additional benefit of the hedges in terms of risk reduction exceeds their cost (the cost includes both lower returns and increased operational costs – including increased compliance costs). However, hedging transactions can be complicated, and an increase in the precision of the hedges will almost always increase compliance costs. For instance, hedging may involve taking short positions in multiple securities and buying or writing options on equities, interest rates or currencies. Perhaps more important from the viewpoint of the stability of the financial system is that a fund adviser can reduce its compliance costs by hedging against fewer adverse events, and especially by reducing hedges against extreme tail events. As discussed in the first paragraph on page two, and more fully explained in the article cited in footnote two, having the adviser pay compliance costs will incentivize the adviser to structure the portfolio in ways that reduce compliance costs even if that structure lowers returns to the fund's investors. This could be exceptionally harmful if the reduction of compliance expenditures entails reducing or eliminating hedges against extreme tail events where the hedges mitigate the magnitude of large losses, but the efficacy of those hedges aren't typically observed by investors since tail events by definition are extremely rare. Having advisers pay compliance costs would be likely to increase the exposure of investors to tail events that the adviser would otherwise have hedged against. Providing disincentives to hedge against extreme events and to have less precise hedges overall will also increase systemic risk. Private funds will be more likely to face margin calls if their hedges are less precise and cover fewer eventualities. This will increase systemic risk.

The Proposed Rules Could Reduce Competition.
There are economies of scale in compliance: the cost of compliance tends to be invariant with the size of individual trades. Larger more established firms will be able to spend money to ensure compliance, but startup advisers are less likely to have the same level of resources. Allowing the costs of compliance to be paid by investors can help overcome that hurdle, but the Proposed Rules would prevent a new entrant from offering that contractual arrangement. The Proposed Rules would also provide an incentive for advisory firms to either get acquired by larger firms, or merge, or exit the industry. The resulting reduction in competition would reduce the impact of private funds on correcting mispricings in markets. Market mispricings tend to eventually correct, but the more out of line they get before correcting, the greater is the cost to the economy both in terms of resource misallocation, but perhaps more importantly, in terms of dislocations in financial markets and consequent disruptions in the availability of credit to the real economy.

The Proposed Rules Provide a Disincentive to Spend Resources on Compliance. It is a basic economic principle that if we constrain the sources of funding for a particular asset, less money will be spent on that asset overall. I believe that the Commission should be enacting regulations that encourage firms to spend *more* overall on regulatory compliance. Unfortunately, I believe that the unintended effect of the Proposed Rules would be to discourage spending on regulatory compliance. By prohibiting advisers from being reimbursed for regulatory and compliance expenses, the advisers will be incentivized to spend less on those expenses generally. Spending on compliance, even holding the portfolio fixed, is not a predetermined sum.

The Proposed Rules' Lack of Clarity Favors More Aggressive Firms. The Proposed Rules do not provide a clear definition of what would be classified as proper regulatory and compliance expenses of a private fund versus the manager. In fact, the Commission acknowledges this lack of clarity in the release, but I fear that the consequences have been underestimated. This ambiguity will provide a competitive advantage to advisers who are more likely to take aggressive positions with regard to their interpretation of the rules. The Proposed Rules would disadvantage advisers who have a robust culture of compliance and transparency. Advisers with a strong compliance culture will be incentivized to gradually leave the industry and become family offices. The regulated adviser industry would then become increasingly dominated by more aggressive firms. This would prevent investors from having the choice of firms with a strong compliance commitment.

As a result of my academic career and my role at WAM, I have both a theoretical and practical understanding of how the Proposed Rules are likely to affect the behavior of market participants. In this context, I have serious misgivings about how the Proposed Rules would affect market participants were they enacted. I believe that the Proposed Rules are likely to actually hurt the very investors that the Commission is seeking to help. As a result, I strongly urge the Commission to withdraw the Proposed Rules regarding prohibited activities.

I appreciate the opportunity to provide comments to the Commission on the Proposed Rules.

Very Truly Yours,

/s/ Andrew Weiss

Andrew M. Weiss
Professor Emeritus, Boston University
Chief Executive Officer, Weiss Asset Management