April 25, 2022

Via Electronic Submission

Secretary Vanessa A. Countryman
U.S. 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 (RIN: 3235-AN07; Release No. IA-5955; File No. S7-03-22)

Dear Ms. Countryman:

We write to express our views on the rules recently proposed by the Securities and Exchange Commission (the "***Commission***") entitled "*Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*" (the "***Proposed Rules***").[1] Our comments are based on our experience and reflect the views of certain of our clients that presently act as private fund managers based in the United States. These clients currently advise private funds with many billions of dollars of assets under management. The majority of our clients do not provide investment advisory services to "retail investors," as defined under the Investment Advisers Act of 1940, as amended (the "***Advisers Act***").[2]

We appreciate the Commission providing this opportunity to present our views regarding the Proposed Rules for its consideration. We have made every effort to address our views specifically to certain portions of the Proposed Rules, and for the remaining portions, we make no comment at this time. We would welcome the Commission's invitation to discuss the contents of this letter or the portions of the Proposed Rule to which we make no comment.

I. INTRODUCTION

We proceed in two parts. First, we discuss the legality and validity of the Proposed Rules, assuming the Commission will adopt the Proposed Rules in substantially similar form as presented. In doing so, we provide our views as to the Commission's statutory authority to adopt certain portions of the Proposed Rules, and we provide our observations as to the content and procedures of the Proposed Rules as they relate to the Administrative Procedure Act (the "***APA***"). Second, for the Commission's

1. Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 5955, 87 Fed. Reg. 16,886 (Mar. 24, 2022) [hereinafter *Proposed Rules*] (to be codified at 17 C.F.R. pt. 275).

2. Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. ch. 2D, subch. II); 15 U.S.C. § 80b–11(g)(2) ("For purposes of this subsection, the term 'retail customer' means a natural person . . . who receives personalized investment advice about securities from a broker, dealer, or investment adviser; and uses such advice primarily for personal, family, or household purposes.").

consideration, we respond to the Commission's specific request on the appropriate standard of care, and we share some likely effects of the Proposed Rules.

Generally, the Proposed Rules will introduce substantial new costs with comparatively few benefits. To summarize, investors will face diminished advisory products and services, both in the variety of fund terms available and in reduced services generally. Due to increased costs and reduced services, investors are likely to see their returns negatively impacted, and investors will have substantially less contact and communication with their advisers. With respect to advisers, the Proposed Rules are likely to, among other things, produce: liquidity problems, workforce attrition, reduced operational capacity, a diversion of resources away from managing investors' capital and to maintaining compliance, increased legal uncertainty (both as to the Proposed Rules' interpretation and application to existing agreements), and similarly, the re-drafting, re-negotiating, and re-executing of existing fund agreements.

II. THE COMMISSION'S AUTHORITY—THE PROPOSED RULES AND THEIR VALIDITY

A. The Standard of Care Rules

The Commission proposes to prohibit an adviser from "[s]eek[ing] reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund," (the "***Standard of Care Rules***").[3]

We note the Commission's observations that some advisers misstate the content of their duties, and we welcome the Commission's efforts to stop advisers from misinforming investors as to the adviser's duties and responsibilities under state and federal securities laws. We agree that private fund agreements ostensibly disclaiming non-waivable duties[4] misstate an adviser's obligations, and consequently, should be disallowed. However, we believe that such "hedge clauses," to the extent they mislead an investor as to the adviser's duties under applicable law, are already prohibited under securities laws prohibiting deceptive practices.[5] In fact, the Commission has pursued enforcement

3. *Proposed Rules*, 87 Fed. Reg. at 16,977 (to be codified at 17 C.F.R. § 275.211(h)(2)–1(a)(5)).

4. *See Proposed Rules*, 87 Fed. Reg. at 16,925 & n.170.

5. *See, e.g.*, 15 U.S.C. § 80b–6; 15 U.S.C. § 78j; Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) ("[Section] 206 establishes federal fiduciary standards to govern the conduct of investment advisers.") (internal quotation marks omitted); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471 n.11 (1977) ("Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers."); *see also* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248, 84 Fed. Reg. 33,669, 33,672 n.31 (July 12, 2019) ("In our view, however, there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with those antifraud provisions, where the hedge clause purports to relieve the adviser from liability for conduct as to which the client has a non-waivable cause of action against the adviser provided by state or federal law.") (withdrawing Heitman Capital Management, LLC, SEC Staff No-Action Letter (Feb. 12, 2007)).

Under existing law, "[t]he adviser owes fiduciary duties only to the fund, not to the fund's investors." Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 881 (D.C. Cir. 2006). The *Proposed Rules* seem to disregard this distinction at times. *See, e.g.*, *Proposed Rules*, 87 Fed. Reg. at 16,889 ("Through our examinations, our staff also has encountered instances where advisers seek to limit their fiduciary duty or otherwise provide that the adviser and its related persons will not be liable to the private fund *or investors for breaching its duties (including fiduciary duties)* or liabilities (that exist at law or in equity)." (emphasis added)); *Proposed Rules*, 87 Fed. Reg. at 16,925 n.173 (citing with approval the proposition that "[fund agreements] have been criticized for waiving and otherwise limiting managers' fiduciary duties *to their investors*" (emphasis added)); *cf.* Sec. &

actions for some of the practices the Commission seeks to prohibit in the Proposed Rules.[6] Similarly, advisers are already liable for willful misfeasance,[7] bad faith,[8] and recklessness[9] in providing advisory services. In effect then, the Standard of Care Rules seem to change the status quo in only one respect: changing the standard of care from gross negligence—the "market" standard—to negligence.[10]

1. The Commission's Statutory Authority to Adopt the Standard of Care Rules

Respectfully, we do not believe that Congress has delegated sufficient authority to the Commission to adopt the Standard of Care Rules. The Commission proffers several statutory bases for its authority.[11] Three of these predicates provide authority over substantive matters, but none bears relation to the Standard of Care Rules.[12] 15 U.S.C. § 80b–6(4) prohibits fraudulent, deceptive, or manipulative acts, but as mentioned previously, to the extent any fraud, deception, or manipulative action occurs, it is already prohibited under existing law.[13] The other two substantive predicates are found in 15 U.S.C. § 80b–11(h), which empowers the Commission to facilitate the provision of simple and clear disclosures[14] and to:

> where appropriate, promulgate rules prohibiting or restricting certain *sales practices*, *conflicts of interest*, and *compensation schemes* for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.[15]

Consequently, it appears the Commission's authority for the Standard of Care Rules rests predominantly, if not entirely, on the latter portion of subsection of 15 U.S.C. § 80b–11(h).[16]

Exch. Comm'n v. Northshore Asset Mang't, No. 05 Civ. 2192 (WHP), 2008 WL 1968299, at *6 (S.D.N.Y May 5, 2008) (in reliance on *Goldstein*, dismissing on summary judgment a claim under Sections 206(1)–(2) of the Advisers Act because the defendant did not owe fiduciary duties to the investors). *But see Proposed Rules*, 87 Fed. Reg. at 16,943 n.295 ("the principal (the client, here a fund)"); *but see also* United States v. Lay, 612 F.3d. 440, 446–47 (6th Cir. 2010) (distinguishing *Goldstein* and allowing a jury to find an adviser owed fiduciary duties to an investor in one of the adviser's funds apparently based on the special circumstances attendant to the adviser's relationship with that particular investor).

6. *See Proposed Rules*, 87 Fed. Reg. at 16,937 ("For example, the Commission has pursued enforcement actions against private fund advisers where the adviser failed to inform investors about benefits that the advisers obtained from accelerated monitoring fees.").

7. *See* Robare Grp., Ltd. v. Sec. & Exch. Comm'n, 922 F.3d 468, 479 (D.C. Cir. 2019).

8. *See* Sec. & Exch. Comm'n v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 194 (1963).

9. *See* Sec. & Exch. Comm'n v. Steadman, 967 F.2d 636, 641 (D.C. Cir. 1992).

10. We note the Commission's request for specific comment as to whether a "gross negligence" standard should instead be adopted, and we have provided a response *infra* Part III.A.1.

11. *Proposed Rules*, 87 Fed. Reg. at 16,970 (citing 15 U.S.C. §§ 80b–3(d), 80b–6(4), 80b–11(a), (h)).

12. 15 U.S.C. § 80b–3(d) prohibits acts not accomplished through instrumentalities of interstate commerce to the extent the same acts are prohibited if they are accomplished through instrumentalities of interstate commerce. 15 U.S.C. § 80b–11(a) authorizes the Commission to issues rules and regulations to exercise the functions and powers conferred to the Commission in Chapter 2D of Title 15 of the U.S. Code.

13. *See supra* Part II.A.

14. 15 U.S.C. § 80b–11(h)(1); *Proposed Rules*, 87 Fed. Reg. at 16,887 & text accompanying n.4.

15. 15 U.S.C. § 80b–11(h)(2) (emphasis added); *Proposed Rules*, 87 Fed. Reg. at 16,887 & text accompanying n.4; *see also* 15 U.S.C. § 80b–11(g) (providing discretionary authority to the Commission to adopt a best-interest standard of care for broker, dealers, and advisers without regard to the interests of the broker, dealer, or adviser) (such standard of care codified as Regulation Best Interest at 17 C.F.R. § 240.15*l*–1).

16. *See infra* notes 87–92 and accompanying text.

However, the Standard of Care Rules do not concern sales practices, conflicts of interest, or compensation schemes, meaning the Commission is without Congressional authorization to adopt the Standard of Care Rules. We address each of these in turn.

First, the Standard of Care Rules are not a restriction on sales practices because they do not apply an adviser's marketing or promotion of its funds.[17] The binding terms of the legal agreements forming the fund are categorically different than sales practices—for example, statements made concerning prior fund performance. In the former case, the terms stipulate the legal obligations, but in the latter case. the conduct at issue markets the fund to the investor. We do not believe the Commission has the authority to require specific legal obligations because it may provide rules related to sales practices.

Second, we believe that classifying the Standard of Care Rules as restricting "conflicts of interest" defines "conflicts of interest" too broadly. Congress views conflicts in narrower terms, applying to cases where an adviser stands on both sides of a transaction.[18] In one such "principal transaction," an adviser directs one of its funds to buy an asset the adviser controls, and as a result, the adviser dictates the purchase price it pays itself using its clients' capital.[19] However, for an adviser to stand on both sides of the transaction, there must be two sides: the adviser must be able to act both in its own capacity *and* on behalf of its clients. The adviser cannot stand on both sides before the advisory relationship is formed because it has no authority to act on its clients' behalf. Before the relationship is formed, the investor and the adviser, vis-à-vis the fund, are in some sense conflicted[20] while negotiating the fund terms, but this is not the sense in which Congress uses the term "conflicts." But this is altogether a different kind of conflict because the investor is acting on its own behalf. Prior to an investor's admittance into the fund, advisers disclose the applicable standard of care to investors, and investors have the opportunity to negotiate the standard of care just as they negotiate other terms. Congress could not have intended to give the Commission authority to dictate all fund terms due to the conflicts of interest inherent in negotiations. For Congress, conflicts of interest are present only after a relationship is formed and the adviser can act both on behalf of its clients, and "for his own account."[21] In this way, we believe the Standard of Care cannot be said to restrict "conflicts of interest" as Congress used the term.

Returning to the statute then, restricting "compensation schemes" would seem to be the only remaining basis for the Standard of Care Rules.[22] The Standard of Care Rules, in part,[23] superficially

17. For an example of rules that would restrict sales practices, see Investment Adviser Marketing, Adviser Act Release No. 5653, 86 Fed. Reg. 13,024 (May 4, 2021).

18. *See* 15 U.S.C. § 80b–6(3) (prohibiting principal transactions wherein an adviser buys an asset from, or sells an asset to, itself on behalf of the adviser's clients without giving advance disclosure and obtaining the clients' consent).

19. Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Advisers Act Release No. 1732, 63 Fed. Reg. 39,505 (July 23, 1998) ("In a principal transaction, an adviser, acting for its own account, buys a security from, or sells a security to, the account of a client.").

20. We do not mean to imply that advisers have no obligations to prospective investors; we simply state the obvious fact that the full panoply of an adviser's duties do not exist prior to a binding agreement for provision of advisory services. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248, 84 Fed. Reg. 33,669, 33,674 n.42 (July 12, 2019) (outlining an adviser's obligations to prospective clients).

21. 15 U.S.C. § 80b–6(3).

22. 15 U.S.C. § 80b–11(h)(2).

23. In addition to limiting reimbursement, advisers would not be able to seek indemnification, exculpation, or limitation of their liability.

restrict a "compensation scheme," insofar as they "would prohibit an adviser . . . from seeking reimbursement."[24] Yet, the Advisers Act, the Commission's regulations, and common usage differentiate between "compensation" and "reimbursement." Compensation is used in the context of fees paid to the adviser for its services, whereas reimbursement refers to the adviser's recoupment of expenses paid.[25] The Advisers Act states that a party may be paid "such *fees for its services* and such *reimbursement for its expenses*."[26] Following "the normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning" suggests that compensation, as used in the Advisers Act, should not be read to encompass reimbursement.[27]

Because the statutory predicates for the Standard of Care Rules do not grant the Commission authority to mandate a standard of care applicable to advisers, we respectfully submit that the proposed amendments exceed the Commission's Congressionally delegated rulemaking powers.

2. Validity of the Standard of Care Rules if Adopted

But assuming the Commission has authority to adopt the Standard of Care Rules, they would be invalid as conflicting with the Advisers Act. In *Goldstein v. Securities and Exchange Commission*,[28] the D.C. Circuit Court of Appeals invalidated rules the Commission adopted that defined "client" in a manner that "comes close to violating the plain language of the statute [and a]t best . . . is counterintuitive . . . ."[29] The proposed rule at issue in *Goldstein* would have included investors in a fund in the count of an adviser's clients for purposes of registering with the Commission.[30] Dismissing the Commission's justifications for the proposed rule, the Court found a "disconnect between the factors the Commission cited and the rule it promulgated."[31]

The Commission's cited justifications for the rule at issue in *Goldstein* are strikingly similar to those now cited in support of the Proposed Rules. Here, the Commission states the rules are needed because "advisers play an increasing role in the economy . . . engag[ing] in trillions of dollars [of] transactions each month," and what's more, "[n]umerous investors also have indirect exposure to private funds through private pension plans, endowments, feeder funds established by banks and other financial institutions, foundations, and certain other retirement plans."[32] With respect to the Preferential

24. *Proposed Rules*, 87 Fed. Reg. at 16,977 (to be codified at 17 C.F.R. § 275.211(h)(2)–1(a)(5)).

25. *Compare* Advisers Act, 54 Stat. at 827 ("such *fees for its services* and such *reimbursement for its expenses* as are provided for in such instrument"), *with id.* at 828 ("the Commission may prescribe as *compensation* for performing . . . *services*"); *compare also* 15 U.S.C. § 80b–5 (setting requirements for advisers' "compensation"), *with Proposed Rules*, 87 Fed. Reg. at 16,927 ("an adviser may pay legal or operating *expenses* of several fund clients and then seek *reimbursement*"); *compare also* Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, H.R. Doc. No. 76-477, at 16 (1939) (most advisers "based their compensation on a percentage of the assets of the funds"), *with* Investment Company Act of 1940 and Investment Adviser's Act of 1940, H.R. Rept. No. 76-2639, at 22 (1940) ("the trustee . . . [is] entitled to *reimburse* itself out of the trust property for its *expenses* actually incurred . . . [but is] prohibited from deriving any fees from the trust") (emphasis added throughout).

26. Advisers Act, 54 Stat. at 827.

27. Sullivan v. Stroop, 496 U.S. 478, 484 (1990) (citations omitted).

28. *See* Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873 (D.C. Cir. 2006).

29. *Id.* at 881.

30. *Id.* at 878.

31. *Id.* at 882.

32. *Proposed Rules*, 87 Fed. Reg. at 16,887.

Disclosure Rules (as defined below), the Commission continues, "Advisers frequently grant preferred terms to certain investors that . . . materially disadvantage other investors in the private fund."[33]

As if the court were reading the Proposed Rules, it recounted the Commission's evidence for the rules the court invalidated in *Goldstein* as "a rise in the amount of hedge fund assets, indications that more pension funds and other institutions were investing in hedge funds, and . . . . a hedge fund adviser sometimes 'may not treat all of its hedge fund investors the same.'"[34] The court's reasoning bears mentioning at length given the similarities:

> But without any evidence that the role of fund advisers with respect to investors *had undergone a transformation*, there is a disconnect between the factors the Commission cited and the rule it promulgated. That the Commission wanted a hook on which to hang more comprehensive regulation of hedge funds may be understandable. But the Commission may not accomplish its objective by a manipulation of meaning. . . . It may be that different classes of investors have different rights or privileges with respect to their investments[, but t]his is in fact a common arrangement throughout the law of business organizations. Many corporations, for example, have different classes of common or preferred stock. Although different classes of stockholders have different rights or privileges, the basic fiduciary duties of managers to shareholders remain uniform.[35]

The court vacated the adopted rules, but Congress ultimately effected part of them when it passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("***Dodd-Frank***").[36]

We believe the Standard of Care Rules rest on an inadvertently manipulated meaning of "conflicts of interest," just as the invalidated rules in Goldstein rested upon a different meaning of "client." The Commission classifies the Standard of Care Rules as restricting a conflict of interest,[37] a term that could be understood in multiple senses.[38] But "it scarcely follows" the Commission is able to choose any of those senses.[39] To ascertain the correct sense, due regard should be given to the statutory context and Congress' purpose in passing the law.[40] Here, the Advisers Act "serves the fundamental purpose of substitut[ing] a philosophy of full disclosure for the philosophy of caveat emptor."[41] After

33. *Id.* at 16,888.

34. *Goldstein*, 451 F.3d at 882 & n.7 (citing Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,069–70 (Dec. 10, 2004) (in turn referencing different lock-up periods, greater access to information, lower fees, and "side pocket" arrangements)).

35. *Goldstein*, 451 F.3d at 882 & n.7 (D.C. Cir. 2006) (emphasis added and footnote text appended to be in-line with the court's opinion).

36. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376, 1571 (2010); Rules Implementing Amendments to the Investment Advisers Act of 1940, Advisers Act Release No. 3110, 75 Fed. Reg. 77,052, 77,072 & n.234 (Dec. 10, 2010) (citing Section 404 of Dodd-Frank, which accomplishes certain recordkeeping requirements invalidated in *Goldstein*).

37. *See Proposed Rules*, 87 Fed. Reg. at 16,925 ("This scope of prohibitions is appropriate because these activities harm investors by placing the adviser's interests above those of its private fund clients (and investors in such clients).").

38. *See supra* Part II.A.1.

39. *Goldstein*, 451 F.3d at 878.

40. PDK Lab'ys Inc. v. DEA, 362 F.3d 786, 796 (D.C. Cir. 2004) ("The words of the statute should be read in context, the statute's place in 'the overall statutory scheme' should be considered, and the problem Congress sought to solve should be taken into account." (quoting Davis v. Michigan Dep't of Treasury, 489 U.S. 803, 809 (1989))).

41. Kokesh v. Sec. & Exch. Comm'n, 137 S. Ct. 1635, 1640 n.1 (2017) (internal quotation marks and citations removed) (emphasis added) (alteration in original); *see also* William W. Clayton, Public Investors, Private Funds, and State Law, 72

all, "if the legislative purpose is to be served, [an investor must] be permitted to evaluate [an adviser's] overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving 'two masters' or only one . . . ."[42]

Even if the Standard of Care Rules rested on the correct meaning of "conflicts of interest,"[43] the rules would still be invalid as conflicting with the Advisers Act's legislative purpose. For other conflicts, Congress chose a two-part remedy: disclosure and consent.[44] Congress did not ban the transaction altogether. In contrast, the Standard of Care Rules do not adopt this two-part remedy; indeed, they cannot because investors already receive disclosure of the standard of care and provide their consent. The Standard of Care Rules eschew disclosure and consent in favor of a ban. By not permitting investors to act on their own evaluations, the Standard of Care Rules do a disservice to the fundamental purpose of the Advisers Act.

We believe that the Commission's reasoning for the Proposed Rules contains the same flaws present in *Goldstein*. The Commission has not provided any evidence that advisers' roles have "undergone a transformation." Instead, the Commission cites the same reasons the D.C. Circuit Court of Appeals found unavailing. The Standard of Care Rules rest on an incorrect interpretation of the Advisers Act, and they pursue goals contrary Congress'. Should the Commission ultimately adopt the Standard of Care Rules, we believe they would be invalidated because "the Commission's rule bears no rational relationship to achieving [Congress'] goal" in the Advisers Act.[45]

3. Compliance with the Administrative Procedure Act

Beyond dissonance with the Advisers Act, the Commission has not complied with the requirements of the APA in advancing the Standard of Care Rules.[46] Adopting them would contravene the purposes behind the notice and comment procedures,[47] be arbitrary and capricious,[48] and as already discussed, exceed the Commission's statutory authority.[49]

The notice and comment procedures of the APA serve several goals, including exposing the regulations to diverse public comment, ensuring fairness to affected parties, and in the case of challenges to the regulations, developing a sufficient record for judicial review.[50] Moreover, notice and comment obliges "the agency [to] maintain[] a flexible and open-minded attitude towards its own

BAYLOR L. REV. 294, 306 (2020) ("Similarly, the Investment Advisers Act is primarily a disclosure-based statute that avoids setting forth substantive requirements that managers must abide by.").

42. Sec. & Exch. Comm'n v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 196 (1963) (emphasis added) (quoting United States v. Mississippi Valley Generating Co., 364 U.S. 520, 549 (2010).

43. As mentioned, Congress uses the term "conflicts of interest" in a sense different than the one that would support the Standard of Care Rules. *See supra* notes 18–21 and accompanying text.

44. 15 U.S.C. § 80b–6(3) (allowing principal transactions if the client consents and the adviser makes certain disclosures to the client).

45. *Goldstein*, 451 F.3d at 883.

46. The Administrative Procedure Act, Pub. L. No. 79-404, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.).

47. 5 U.S.C. § 553; *see also* United States v. Nova Scotia Food Prod. Corp. 568 F.2d 240, 248–50 (2d Cir. 1977).

48. 5 U.S.C. § 706(2)(A).

49. 5 U.S.C. § 706(2)(C); *see supra* Part II.A.1.

50. Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 407 F.3d 1250, 1259 (D.C. Cir. 2005).

rules."[51] While the Commission has perhaps facially complied with the statutory requirements,[52] the Commission has disregarded judicial precedent and the purposes those requirements serve, to "as a whole and in each of its major aspects provide[] a degree of public awareness, understanding, and participation commensurate with the complexity and intrusiveness of the resulting regulations."[53]

In the past ninety days, the Commission has issued at least six proposals affecting investment advisers, each with condensed timelines for public comment; these proposals span hundreds of pages working "complex[] and intrusive[]"[54] changes to securities laws.[55] So much so, a former staff member of the Commission opined, "I think you'd be hard-pressed to find any four-month period where the [C]ommission has been this active on the rulemaking front across such a broad swath of the market . . . The rules aren't just significant in their scope, they're seismic in their impact."[56]

As a result of the short comment periods and volume of proposals, the public and those affected have not had the opportunity to appropriately consider, research, and develop thoughtful views as to the Commission's proposals. Indeed, as of the submission of this letter, fewer than 100 comment letters have been posted, and of those, over half are less than a page in length.[57] With more time, we would have considered and addressed more portions of the Proposed Rules, as well as other proposals the Commission has put forth.[58] In contrast to the thirty days allowed for public comment to the Proposed Rules (and other proposals), the Commission considered Regulation Best Interest over the course of a year, received over 6,000 comment letters, held a series of investor roundtables, provided a "feedback form" for the public to complete, and met in person with over 200 people.[59] Regardless

51. Nat'l Tour Brokers Ass'n v. United States, 591 F.2d 896, 902 (D.C. Cir. 1978).

52. *See* 5 U.S.C. § 553(b)–(c) (requiring, amongst other things, a statement of the subject matter, reference to the agency's legal authority, and giving the public an opportunity to provide its views).

53. Weyerhaeuser Co. v. Costle, 590 F.2d 1011, 1028 (D.C. Cir. 1978).

54. *Id.*

55. *See, e.g.*, Money Market Fund Reforms, Investment Company Act Release No. 34,441, 87 Fed. Reg. 7248 (Feb. 8, 2022) (109 pages); Amendments to Form PF To Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, Advisers Act Release No. 5950, 87 Fed. Reg. 9106 (Feb. 17, 2022) (130 pages); Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, Advisers Act Release No. 5956, 87 Fed. Reg. 13,524 (Mar. 9, 2022) (72 pages); Modernization of Beneficial Ownership Reporting, Securities Act of 1933 Release No.11,030, 87 Fed. Reg. 13,846 (Mar. 10, 2022) (54 pages); Short Position and Short Activity Reporting by Institutional Investment Managers, Exchange Act Release No. 94,313, 87 Fed. Reg. 14,950 (Mar. 16, 2022) (71 pages); Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 5955, 87 Fed. Reg. 16,886 (Mar. 24, 2022) (92 pages); The Enhancement and Standardization of Climate-Related Disclosures for Investors, Securities Act of 1933 Release No. 11,042, 87 Fed. Reg. 21,334 (Apr. 11, 2022) (140 pages). All told, these proposed rules constitute over 600 pages of the Federal Register.

56. Al Barbarino, *One Year In, SEC's Gensler Has Delivered A Rulemaking Storm*, LAW360 (Apr. 15, 2022), https://www.law360.com/articles/1484431 (citing a former assistant director of enforcement of the Commission) (alterations removed).

57. *See* SEC. & EXCH. COMM'N, *Comments on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, https://www.sec.gov/comments/s7-03-22/s70322.htm (last visited Apr. 25, 2022, 1:44 PM).

58. For example, we would have provided input on the standardization of return calculations, management and performance fees calculations, and further delineated the impact of making some key terms in funds uniform. In addition, we would have provided our views on the increased disclosure obligations and how they might result in increased competition, and costs, across funds. For other parts of the Proposed Rules, we would have offered our considerations as to the likely impacts the Proposed Rules would have on market efficiency and capital formation.

59. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,320 (July 12, 2019) (codified at 17 C.F.R. § 240.15*l*–1); *see also* XY Plan. Network, LLC v. Sec. & Exch. Comm'n, 963 F.3d 244, 250 (2d Cir.

of whether such a thorough process is required here,[60] the discrepancy between overlapping and concurrent thirty-day windows for the many recent proposals stands in stark contrast, especially considering that most affected parties are in the process of fulfilling their existing regulatory obligations for the prior fiscal year.[61]

Exacerbating the potential harm of this procedure, the Standard of Care Rules and the Preferential Disclosure Rules (as defined below) would impact approximately 12,500 advisers with over $18 trillion in assets under management.[62] Notably, the Commission then relays that it is "difficult to quantify" both the costs and benefits of the Proposed rules due to "a lack of data."[63] When there is a lack of data as to both the costs and benefits of a proposal, we believe forbearance to be the best course, at the very least until the effects on such a large proportion of the American and global economies are better understood. It seems the cart has been put before the horse.

In addition to the notice and comment shortcomings, if the Proposed Rules are adopted in substantially the same form as proposed, the Commission's actions will be arbitrary and capricious.[64] The Commission will have "relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, [and] offered an explanation for its decision that runs counter to the evidence before the agency."[65] Congress has instructed the Commission to consider the public interest, protection of investors, and whether the action will promote efficiency, competition, and capital formation.[66] We do not doubt the Commission seeks to protect investors (though we do doubt whether investors will benefit from the Proposed Rules), but the Proposed Rules give short shrift efficiency, competition, and capital formation primarily.[67]

2020) (summarizing with approval the Commission's process in promulgating Regulation Best Interest); Note, *Securities Regulation—Pay Ratio Disclosure*, 129 HARV. L. REV. 1144, 1145 (2016) (citing Pay Ratio Disclosure, 80 Fed. Reg. 50,104 (Aug. 18, 2015) (to be codified at 17 C.F.R. pts. 229, 240, 249)) (stating the Commission received over 287,000 comment letters during rulemaking).

60. *But see infra* note 62 and accompanying text.

61. For example, surrounding the due dates for public comment to the Commission's proposal, registered investment advisers must complete, amongst other filings: Form ADV, Form PF, Form 13G, Form 13H, Rule 4.13(a)(3) affirmations, Rule 4.18(a)(8) affirmations, Schedule K-1s. *See also* Beth Shanker, Comment Letter on the *Proposed Rules* (Apr. 12, 2022), https://www.sec.gov/comments/ s7-03-22/s70322-20123503-279718.htm.

62. *Proposed Rules*, 87 Fed. Reg. at 16,935.

63. *Proposed Rules*, 87 Fed. Reg. at 16,948.

64. We again note that the following standards are applicable to final rules, not proposed rules, if a proper litigant brought suit as some commenters have suggested.

65. Walter O. Boswell Mem'l Hosp. v. Heckler, 749 F.2d 788, 798 (D.C. Cir. 1984) (citing Motor Vehicle Manuf. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)).

66. 15 U.S.C. § 80b–2(c); *see* Commissioner Hester Peirce and Commissioner Elad L. Roisman, *Falling Further Back—Statement on Chair Gensler's Regulatory Agenda* (Dec. 13, 2021), https://www.sec.gov/news/statement/peirce-roisman-falling-further-back-121321 ("The Regulatory Flexibility Agenda neglects to include a single item designed to help companies raise capital. Indeed, several items listed are poised to do the exact opposite." (parenthetical defining term omitted)). We note the Regulatory Flexibility Agenda included mention of the Proposed Rules when Commissioners Peirce and Roisman made their statement. *See id.* n.1; OFF. INF. & REG. AFF., *Agency Rule List—Fall 2021: Securities and Exchange Commission*, https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235&csrf_token=F93DDA75B0D952E153B7019FC53F68D720E4F59FC01A0970832F3257162E20C7F1A9A0711058A0E670BDD754797D30C59BC4.

67. *See Proposed Rules*, 87 Fed. Reg. at 16,955–56 (analyzing the Proposed Rules' effects on the same).

Adopting the Proposed Rules would be arbitrary and capricious because the Commission has entirely neglected to consider "the public interest," despite it being repeatedly mentioned. Reflexively, the Proposed Rules reference "the public interest" as if completely synonymous with investor protection or benefit.[68] In each case and with little variation, the Proposed Rules say a certain practice is "contrary to the public interest and the protection of investors."[69] However, the Proposed Rules then speak only to the benefits investors might enjoy. In contrast, when Congress refers to public interest, it almost uniformly refers to "the public interest *or* investor protection,"[70] suggesting the terms have distinct applications. In its findings, Congress views investment advisers as important in part because transactions by advisers "affect . . . the national economy."[71] It would seem then, that the public interest has more to do with the nation's interest as a whole, and investor protection concerns the subset of the nation that invests with advisers.

But of the Proposed Rules' nation-wide impact, there is no mention. We believe the potential nation-wide impact is one of the most important aspects of the Proposed Rules. Analysts estimate that private equity funds (which are only a subgroup of the entities impacted by the Proposed Rules) back 16,000 companies[72] and account for 6.5% of the United States' gross domestic product.[73] Just because the Proposed Rules do not directly regulate the 11.7 million workers employed by private equity funds,[74] it does not follow that the downstream effects of adopting the Proposed Rules are irrelevant. The Proposed Rules state that some advisers and funds may lose employees as a result of these rules, but there is no consideration of how cutting advisers' operations and capacity might affect the millions of other employees indirectly impacted by the Proposed Rules.[75] When Congress directed the Commission to consider the public interest, we believe these downstream effects on the economy are the exact issues Congress wished to be considered. Adopting the Proposed Rules would be arbitrary and capricious because the Commission has "entirely failed to consider an important aspect of the problem."[76]

In its efforts to protect investors, the Commission has conflated certain fund terms some, and perhaps many, investors desire with "protecting" investors generally, and as a result the Commission has failed to consider investor protection. Such a mélange of terms negatively impacts all investors, including those who wish to see the Proposed Rules adopted in their entirety. The Standard of Care Rules would increase uniformity across funds, depriving investors (for their apparent protection) of more varied investment products.[77] While some investors may value a fund indemnifying against

68. *See, e.g.*, *Proposed Rules*, 87 Fed. Reg. at 16,886, 16,889, 16,890, 16,925, 16,944, 16,969; *see also* 15 U.S.C. § 80b–1(3) (Congress providing as one of its findings in the Advisers Act that "[investment adviser] transactions occur in such volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking system *and the national economy*." (emphasis added)).

69. *Id.*

70. *See, e.g.*, Advisers Act §§ 6(e), 8(a), 12(a), 54 Stat. at 802, 803, 808–09, respectively.

71. 15 U.S.C. §80b–1(3) (expressing Congressional findings).

72. ERNST & YOUNG, *Economic Contribution of the US Private Equity Section in 2020*, 3 (May 2021), https://www.investmentcouncil.org/wp-content/uploads/ey-aic-pe-economic-contribution-report-final-05-13-2021.pdf

73. *Id.* at 5.

74. *Id.*

75. *See Proposed Rules*, 87 Fed. Reg. at 16,944 ("[A]dvisers may also face . . . loss of employees . . . .")

76. Motor Vehicle Manufacturers Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).

77. *See also Proposed Rules*, 87 Fed. Reg. at 16,937–40 (discussing the fact that investors seek to negotiate or invest in funds based on the funds' different practices that the Proposed Rules seek to standardize); *id.* at 16,939 ("[P]rospective investors

negligence only, other investors, in pursuit of higher returns, may prefer the added risk of indemnifying against gross negligence (however small or large that risk might be in the investor's estimation).[78] In the name of investor protection, some investors will be unable to access the higher yielding funds they might otherwise desire.

In seeking to standardize certain fund terms,[79] the Commission has relied on its views as to what investors should accept, rather investor protection. Implicitly, the Commission recognizes the difference. When advisers harm investors—in other words when investors need protection—the Commission brings an enforcement action. The Commission cites instances where it has done just that, though the cases often involve a lack of disclosure,[80] rendering the investor unable to make an informed decision as to the level of risk he was taking on. The Commission now seeks to classify properly disclosed actions as harmful because those actions were harmful when they were not disclosed. The Commission is right to say that failing to inform investors of fees or misinforming as to the applicable standard of care harms investors, but the proper course is not to forbid fees or mandate standards. Rather, the Commission should take swift action against wrongdoers, as it has already done, under its existing rules. Instead, the Commission relies on reasons beyond investor protection and harm prevention to propose a rule forbidding far more than harm.

Adding another layer to the arbitrary and capricious nature of the Proposed Rules, the cited explanations run counter to some of the cited evidence, and in many other cases, there is no evidence at all that the Proposed Rules will accomplish their intended effects.[81] For example, the Commission cites the rapid rise in the size of the market, in terms of investors, advisers, and assets under management as requiring additional regulation.[82] However, the influx of capital and investors suggests the market is functioning well.[83] In contrast to the well-documented "votes" of investors in the private

. . . may use this information in conducting due diligence, in deciding whether to seek to negotiate the terms of investment, and ultimately in deciding whether to invest in the adviser's fund.").

78. *See infra* Part III.A.1. Those higher returns may result from decreased insurance premiums, advisers making riskier investments (after proper disclosure of course), or lower compliance costs than would otherwise be incurred in ensuring a higher standard of care throughout both an adviser's operations, as well as those of its service providers.

79. We decline to reiterate the fact that the Commission lacks statutory authority to disallow certain agreements, except in narrowly defined circumstances. *See, e.g.*, 15 U.S.C. § 80b–5(f) (permitting the Commission to promulgate rules prohibiting mandatory arbitration clauses for disputes arising under federal securities laws). The Commission has apparently declined to exercise this authority.

80. *See Proposed Rules*, 87 Fed. Reg. at 16,937 ("For example, the Commission has pursued enforcement actions against private fund advisers where the adviser failed to inform investors about benefits that the advisers obtained from accelerated monitoring fees.").

81. *See* Encino Motorcars, LLC v. Navarro, 579 U.S. 211, 221 (2016) ("One of the basic procedural requirements of administrative rulemaking is that an agency must give adequate reasons for its decisions."); Ethyl Corp. v. Env't Prot. Agency, 541 F.2d 1, 97–98 (D.C. Cir. 1976) (Wilkey, J., dissenting) ("Certainly a determination made in the absence of any evidence in the record to support it would lead a reviewing court to conclude that a 'clear error of judgment' had occurred. . . . Since a court must review 'the entire record,' it may well be that the evidence detracting from the agency's conclusion is so overwhelming or so persuasive, or the agency's approach so one-sided, or the decision-making process so flawed, that a reviewing court must conclude that the agency erred in the exercise of its rulemaking power. Or, if there is an essential point or element missing in the logical progression toward the conclusion that the agency reaches, then the agency's action likewise may be arbitrary or capricious, because it is not supported by a logical thought process.").

82. *Proposed Rules*, 87 Fed. Reg. at 16,887.

83. MCKINSEY & CO., *McKinsey Global Private Markets Review 2022* 5–12 (Mar. 2022), https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/mckinseys-private-markets-annual-review (documenting the rise in investors' allocations to private markets and the large returns these investors receive)

fund market, Part V.C.3. of the Proposed Rules amounts to an *ipse dixit*, listing all possible outcomes to the Proposed Rules' adoption, and that in all cases, investors will benefit.[84] To take but one instance, with respect to the Compliance Expense Rules, the Commission states, "The benefit to investors would be to lower charges on the funds they have invested in, which could increase returns, and potentially lower the cost of effort to avoid and evaluate such charges, or a combination of these benefits,"[85] but then on the next page, the Commission concludes the section saying, "As a result, the cost of the prohibition to investors could thus include a combination of the cost of lower returns and the cost of avoiding such reductions in returns."[86] Thus, in the name of investor protection, the investor is left to find out whether its returns will be higher or lower.

With both the lack of evidence and equivocation as to the Proposed Rules' effects, it bears mention that the Commission is arbitrarily and capriciously reversing its recent policy by implication. Just a few years ago, the Commission declined to adopt a standard of care for advisers pursuant to its authority in Section 913(f) of Dodd-Frank.[87] There, Congress gave the Commission the authority for a one-time[88] rulemaking to specifically address an investment adviser's standard of care for any of its customers.[89] In response, the Commission promulgated Regulation Best Interest, and given the broad sweep of its authority, it could have adopted an equally broad standard if it chose to do so. But for the benefit of interested readers, Section 913(f) of Dodd-Frank was not codified into the United States Code because it only provided for an isolated, one-time use of the powers granted.[90] In of itself, the fact that Congress did not make this authority permanent says much about the Commission's authority to now issue the Standard of Care Rules under a different authority.[91] Moreover, to inform the Commission's rule under Section 913(f), Congress commissioned a study, apparently recognizing both the complexity of the issue and the need for thoughtfulness in adopting a standard of care.[92] After

84. Part V.C.3. of the Proposed Rules addresses the benefits and costs of the Prohibited Activities and Disclosure of Preferential Treatment" rules, which contains the Standard of Care Rules, the Preferential Disclosure Rules, and the Compliance Expense Rules, as well as other rules to which we make no comment. *See Proposed Rules*, 87 Fed. Reg. at 16,948–55. While investor protection is a basis for the Commission's rulemaking, investor benefit is not. *See* 15 U.S.C. § 80b–11.

85. *Proposed Rules*, 87 Fed. Reg. at 16,948.

86. *Id.* at 16,949.

87. Dodd-Frank Act § 913(f), 124 Stat. at 1829.

88. *See id.* (providing for "*a* rulemaking" based on "*a* study" in a note to 15 U.S.C § 78o (emphasis added)).

89. *Id.*, 124 Stat. at 1827–28 ("The Commission may commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to such retail customers.").

90. *See supra* notes 88–89 and *infra* note 91.

91. *See* TRW Inc. v. Andrews, 534 U.S. 19, 31 (2001) ("It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." (citing Duncan v. Walker, 533 U.S. 167, 174 (2001) (internal quotation marks omitted)). For the avoidance of doubt, public laws are statutes. *See* Lawrence M. Solan, *Private Language, Public Laws: The Central Role of Legislative Intent in Statutory Interpretation*, 93 GEO. L.J. 427, 485 (2005); *see generally* VALERIE C. BRANNON, CONG. RSCH. SERV., R45153, STATUTORY INTERPRETATION: THEORIES, TOOLS, AND TRENDS (2018).

92. *See* Dodd-Frank Act § 913(b), 124 Stat. at 1824–25.

thoroughly informed consideration,[93] the Commission declined to adopt a standard of care for investment advisers.

Now, not only does the Commission reverse that policy, it also offers explanations wholly antithetical to the reasons it then chose the *opposite* policy. The Commission now believes it should adopt a standard of care because it prevents investor harm and promotes the public interest.[94] When the Commission chose *not* to adopt a standard of care, it said:

> Adopting a "one size fits all" approach would risk reducing investor choice and access to existing products, services, service providers, and payment options, and would increase costs for firms and for retail investors in both broker-dealer and investment adviser relationships. *Moreover, applying a new uniform standard to advisers would mean jettisoning to some extent the fiduciary standard under the Advisers Act that has worked well for retail clients and our markets and is backed by decades of regulatory and judicial precedent*. Our concerns about the ramifications for investor access, choice, and cost from adopting either of these approaches are not theoretical. With the adoption of the now vacated Department of Labor ("DOL") Fiduciary Rule, there was a significant reduction in retail investor access to brokerage services, and we believe that the available alternative services were higher priced in many circumstances.[95]

To support its reasoning, the Commission cited empirical studies showing that over half of the industry participants affected by the DOL Fiduciary Rule eliminated or reduced their services, almost 70% moved from open-choice to fee-based or otherwise limited brokerage services, and nearly a third expected to move clients (particularly those with low account balances) into robo-advisory accounts.[96] For those retail customers who suffered reduced services, 63% chose to move to self-directed accounts because of the undesirable effects and constraints of a fee-based model.[97] The results of the DOL Fiduciary rule are shocking, and it is odd they go without any mention in the Proposed Rules considering the similar concerns about the Proposed Rules' effect on fees.[98]

With respect to reversals such as these, the Supreme Court has made it clear: "'Unexplained inconsistency' in agency policy is 'a reason for holding an interpretation to be an arbitrary and capricious change from agency practice.' An arbitrary and capricious regulation of this sort is itself unlawful and receives no *Chevron* deference."[99] The flip-flop here is dizzying in multiple respects: (i)

93. *See supra* note 59 and accompanying text (summarizing the Commission's consideration of Regulation Best Interest during a year-long process, supported by 6,000 comments letters, roundtables, and in-person interviews with over 200 people).

94. *Proposed Rules*, 87 Fed. Reg. at 16,951.

95. Regulation Best Interest, 84 Fed. Reg. at 33,322 (citations omitted) (emphasis added). We understand the context for Regulation Best Interest is marginally different, as the Commission was considering a standard of care for brokers and dealers as well as investment advisers, but we do not believe this difference changes the application of the Commission's reasoning. While others may distinguish the circumstances surrounding Regulation Best Interest from those of the Standard of Care Rules, to us, trying to compartmentalize the two as categorically different misses the forest for the trees. *See id.* at 33,321–22 (explaining the contextual differences and stating Regulation Best Interest is "designed to . . . provide clarity with respect to the *standards* of conduct applicable to investment advisers *and* broker-dealers, and foster greater consistency in the level of protections provided by each regime" (emphasis added)).

96. *Id.* 33,322 n.33.

97. *Id.* at 33,322 n.34.

98. *Proposed Rules*, 87 Fed. Reg. at 16,948; *see also* Part III.A.

99. *Encino Motorcars*, 579 U.S. at 212; *see also* Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984); Greater Boston Telev. Corp. v. FCC, 444 F.2d 841, 852 (1970), *cert. denied*, 403 U.S. 923 (1971) ("An agency changing its

now-proposed policy is the opposite of the prior policy; (ii) the reasons for the new policy are the obverse of the empirically-supported reasons for the old policy; (iii) the inconsistency is neither acknowledged nor explained; and most quixotically (iv) in the span of just a few years, both of these paradoxical polices have been supported as promoting the public interest and investor protection. Considering the interpretation of the statutory authority for these rules is already in question, *Chevron* deference is particularly important if the rules were to survive a challenge. The apparent about-face removes a valuable defense of that authority.

* * *

The Standard of Care Rules, if adopted, would exceed the Commission's statutory authority to promulgate rules and regulations. But even if the Commission had such authority, it would be exercising it arbitrarily and capriciously due to the manner in which it has proposed the rules, the substantive reasons given therefor, and the limited opportunity for public comment. On these grounds, we believe the Standard of Care Rules would be vacated if challenged.

B. Compliance Expense Rules

The Commission also seeks to prohibit other common agreements, such as advisers recouping compliance expenses, including those related to examinations or investigations (the "***Compliance Expense Rules***").[100] Here too we believe the Commission lacks statutory authority to prohibit these agreements for reasons we need not fully rehash, and to the extent that wrongdoing occurs, existing law and regulations already forbid it.[101] We do not believe that funds paying their applicable portion of compliance expenses (such as Form ADV expenses[102]) constitutes a "sales practice" as the Commission suggests.[103] As mentioned, "sales practices" refers to marketing and promoting an adviser's services, as allowed under the applicable rules. For example, the Commission's recently adopted marketing rule clearly regulates sales practices.[104] It is unclear exactly how expense-sharing arrangements would exist within the same category as paid testimonials. Expense-sharing terms neither present a conflict of interest because the adviser is usually not "standing on both sides," not to mention the adviser, the fund, and the underlying investors all share in the adviser's interest of maintaining compliance with applicable laws. In our experience, for the cases involving actual conflicts, fund terms protect investors against the conflict, a result in keeping with the adviser's fiduciary duties to the fund. For example, where an adviser seeks reimbursement for wrongdoing, fund agreements provide that to the extent that an adviser violates its standard of care, the adviser

course [must] supply a reasoned analysis indicating that prior policies are being deliberately changed, not casually ignored, and if an agency glosses over or swerves from prior precedents without discussion it may cross the line from tolerably terse to intolerably mute.").

100. *Proposed Rules*, 87 Fed. Reg. at 16,977 (to be codified at 17 C.F.R. § 275.211(h)(2)–1(a)(2)–(3)).

101. *See* Andrew J. Bowden, then-Dir., Off. of Compl. Inspns. & Exams., U.S. Sec. & Exch. Comm'n, *Address at the Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity* (May 6, 2014) ("When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law . . . .").

102. *See Proposed Rules*, 87 Fed. Reg. at 16,922 (stating the Compliance Expense Rules would prohibit funds from contributing towards Form ADV expenses).

103. *Proposed Rules*, 87 Fed. Reg. at 16,929.

104. *See* Investment Adviser Marketing, Adviser Act Release No. 5653, 86 Fed. Reg. 13,024 (May 4, 2021) (codified at 17 C.F.R. pts. 275 and 279).

must return any funds it received. In cases where wrongdoing seems likely at the outset, some funds require a bond to be posted to ensure the fund is not left holding the bag.

But in addition to the lack of statutory authority for the Compliance Expense Rules, we believe the rules also share the same evidentiary and APA flaws as the Standard of Care Rules.[105] For example, the Commission often cites the informational benefits investors will receive as a result of the increased disclosures that would be provided as a result of the Proposed Rules' adoption.[106] The Commission even states that some of the costs of the newly-required disclosures "could be imposed on funds, and therefore indirectly passed on to investors."[107] If the Compliance Expense Rules would allow expense sharing for any regulatory expense (which it is not clear they would), we cannot discern a meaningful difference from the fund sharing in the cost of some benefits it receives but not others.[108] The Commission did not rationalize this discrepancy in the Proposed Rules.

It is also unclear how the Compliance Expense Rules harmonize with the Standard of Care Rules. Under the Compliance Expense Rules, settlements or fines paid in connection with a Commission investigation or examination could not be charged to any fund under its proposal.[109] Clearly, such fines would "be associated with . . . an investigation,"[110] but advisers rarely admit wrongdoing in these settlements.[111] If the advisers do not admit to wrongdoing, then so far as the Standard of Care Rules are concerned, the adviser could seek reimbursement. Of course, more specific provisions (like the Compliance Expense Rule) control more general ones (like the Standard of Care Rules), but we believe the Commission has not properly acknowledged or explained this difference. It is of course inequitable to require an investor to reimburse an adviser for penalties the adviser deserves, but we do not see why the Compliance Expense Rules were needed if the vast majority of fund agreements (not to mention the Standard of Care Rules) prevent the inequity in the first place, whether by bond or otherwise. Investors and advisers are better suited to tailor their affairs to meet their needs. We are wary as to how these provisions might be reconciled, but we believe the discrepancy reflects the underlying arbitrariness of the lines the Proposed Rules draw.

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105. *See* Simmons v. Interstate Com. Comm'n, 829 F.2d 150, 155–56 (D.C. Cir. 1987) ("[A]n agency is always expected to rationalize its action in the rulemaking context." (footnote omitted)).

106. As the Commission summarizes, "In analyzing the effects of the proposed rules, we recognize that investors may benefit from access to more useful information about the fees, expenses, and performance of private funds." *Proposed Rules*, 87 Fed. Reg. at 16,943.

107. *Id.* at 16,946.

108. We understand the Commission was referring to cost-sharing in the context of quarterly disclosures, which could be differentiated on the basis of providing information particularized to an investor, but this seems to be a difference without consequence. If the Commission believes regulatory disclosures provide valuable information an investor can use to its benefit, then it seems the investor likewise obtains a particularized benefit from the non-reimbursable activities, just as the Commission believes the investor would after receiving the additional disclosures the Proposed Rules would require.

109. *Proposed Rules*, 87 Fed. Reg. at 16,922 n.156.

110. *Id.* at 16,977.

111. *See, e.g.*, Northwest Advisors, Inc., Advisers Act Release No. 5830 (Aug. 24, 2021), https://www.sec.gov/litigation/admin/2021/ia-5830.pdf ("without admitting or denying the findings herein, except as to the Commission's jurisdiction"); Crown Capital Securities, L.P., Advisers Act Release No. 5760 (June 24, 2021), https://www.sec.gov/litigation/admin/2021/34-92258.pdf (same).

III. PRACTICAL IMPLICATIONS

In addition to our concerns regarding the legality and validity of the Proposed Rules, we now respond to some issues on which the Commission has requested comment. Where appropriate, we also share our views as to the likely outcomes and market responses to the Proposed Rules.

In general, we are concerned the Proposed Rules would subject the fund industry to substantial legal uncertainty, an industry that "plays an increasingly important role in the economy . . . [and] in the lives of everyday Americans."[112] Throughout the Proposed Rules it is suggested that insofar as they negate existing fund terms, existing agreements would require reconciliation with the new rules.[113] For funds with binding agreements containing terms ostensibly voided under the Advisers Act,[114] advisers would apparently be left to re-draft, re-negotiate, and re-execute existing agreements instead of managing the capital with which investors had entrusted the adviser. To the extent this results in additional money, time, and manpower negatively affecting an adviser's operations or resulting in an adviser's "loss of employees," the Proposed Rules justify the decline as "a transfer to investors."[115] Introducing workforce attrition, lack of continuity, and resource-intensive changes to the entities managing investors' money is doubtful to result in any of the goals Congress has charged the Commission with pursuing, much less benefit investors. If advisers must spend time reworking existing contracts—of which there are many—it is foreseeable advisers will have less time to devote to improving investor returns, investors' primary, if not sole, concern. Unfortunately, for the thousands of investors who are otherwise happy with their fund investments, advisers in the near-term will have to allocate time and resources away from the services that made those investors happy and to becoming compliant with the newly imposed obligations.

The negative market outlook resulting from inflation, quantitative tightening, and geo-political factors only compounds the problems engendered by the uncertainty the Proposed Rules bring.[116] In the more troubling of possible scenarios, the confluence of drastic regulatory change and an economic downturn could result in some advisers' insolvency. While some may find it hard to have sympathy for fund managers, an adviser's financial health directly affects the retired teachers, firefighters, and first responders whose retirement savings are invested with those managers.[117] To us, it seems that for the foreseeable future, the well-intentioned Proposed Rules are much more likely to result in harm to investors, with the prospect of benefits far removed. The Commission should, to borrow a phrase, "first, do no harm."[118]

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112. *Proposed Rules*, 87 Fed. Reg. at 16,887.

113. *Id.* at 16,948 ("This prohibition would impose direct costs on advisers from the need to update their charging and contracting practices to bring them into compliance with the new requirements."); *id.* at 16,949 ("In addition, any such fund restructurings that are undertaken would likely impose costs that would be borne by advisers.").

114. *See* 15 U.S.C. § 80b–15 (voiding any contractual provision violating the Advisers Act or the rules thereunder, including provisions between third parties if such third party had "actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision").

115. *Proposed Rules*, 87 Fed. Reg. at 16,944.

116. Scott Horsley, *Many forecasters believe a recession is coming*, NPR (Apr. 11, 2022), https://www.npr.org/2022/04/11/1092117565/many-forecasters-believe-a-recession-is-coming.

117. Greg Iacurci, *Why the GameStop frenzy may hurt retirees along with hedge funds*, CNBC (Feb. 1, 2021), https://www.cnbc.com/2021/02/01/why-the-gamestop-frenzy-may-hurt-retirees-along-with-hedge-funds.html.

118. Robert H. Shmerling, *First, do no harm*, HARV. HEALTH BLOG (June 22, 2020), https://www.health.harvard.edu/blog/first-do-no-harm-201510138421 ("[I]t is a reminder that we need high-quality

A. The Standard of Care Rules

1. *Question: Should this aspect of the final prohibited activities rule prohibit limiting liability for "gross negligence," or would prohibiting limitations of liability for ordinary negligence, as proposed, be more appropriate? Why?*

In this instance, we believe that if it chooses to adopt a standard at all, the Commission should adopt a gross negligence standard. The Commission should seek to minimize any disruptions to the private fund industry, as most available metrics suggest that investors find investing their money with advisers an attractive proposition. Moreover, for other systemically important financial institutions, Congress has itself adopted a gross negligence standard for their management.[119] While the standard of care is a crucial term, many funds have other internal limits and checks on the indemnity advisers may access. For example, some funds indemnify only out of fund assets (rather than capital calls), others indemnify only after insurance and other funding sources are exhausted, and still others limit an investor's indemnity obligation to its capital commitment, or some combination of the three.

Moreover, we have seen gross negligence as the standard used in many professional service contracts, such as accounting, consulting, and banking. Consistent with this fact, the standard of liability is homogenous throughout a fund's constituent documents and agreements with third-party service providers, lenders, other funds, and many other parties. In other words, if the adviser's standard of care to the fund is a gross negligence standard, any service providers will also be subject to a gross negligence standard in providing their services to the fund. While the Proposed Rules would void provisions in contracts between the fund and the adviser,[120] they would not affect those same provisions in agreements with the other counterparties.[121] As a result, advisers could be put in the position of insuring against third-parties' negligence. To illustrate the problem, if an agreement between a fund administrator and the fund provides that the administrator will indemnify the fund for the administrator's gross negligence, and the administrator's negligence results in substantial losses to the fund, then the adviser must cover that cost under the Standard of Care Rules. Advisers will thus be monetarily responsible for the actions of a party it does not control. Advisers will resort to other sources of funding or revenue as a stopgap measure, including through increased management fees, but increased funding does not resolve the misalignment between the standards for advisers and their contracted service providers.

Of all of the Standard of Care Rules' effects, most puzzling is the result that private funds would be required to have a standard of care more exacting than the standard of care Congress selected for

research to help us better understand the balance of risk and benefit for the tests and treatments we recommend. Ultimately, it is also a reminder that doctors should neither overestimate their capacity to heal, nor underestimate their capacity to cause harm.").

119. *See* Financial Institutions Reform, Recovery and Enforcement Act, Pub. L. No. 101-73, § 212(k), 103 Stat. 183, 243 (1989) (codified as amended at 12 U.S.C. § 1821(k)) (applying a gross negligence standard for directors and officers of insured depository institutions).

120. *See supra* notes 113–114.

121. *See* 15 U.S.C. § 80b–15(b)(2); 17 C.F.R. §275.211(h)(2)–1(a)(2). In conjunction, these provisions would void the contractual rights of any person not a party to the agreement between the adviser and the private fund if that person had actual knowledge that the so-acquired rights violated the Advisers Act at the time the third party entered the agreement. Clearly, these third-parties could not be charged with actual knowledge of a prohibition that did not exist at the time it acquired its rights.

registered public funds under the Investment Company Act of 1940 (as amended, the "***Company Act***").[122] It is unclear to us why, save a single word ("gross"), the Proposed Rules adopt the Company Act standard of care, even including the anachronistic "misfeasance" instead of "misconduct."[123] If it is doubtful the Commission has the authority to promulgate a standard of care, it is doubly dubious it may promulgate one stricter than Congress did for registered public funds.

But putting these prudential concerns to the side for a moment, it is important to remember that investors have the opportunity to negotiate the standard of care, engage with the adviser directly to resolve their concerns, and ultimately, choose not to invest if the adviser does not address those concerns. If displeasure with negotiated outcomes—to which investors consent and receive proper disclosure—empowers the Commission to require or prohibit certain terms on the basis of the "public interest," then we see no limit to what the Commission may mandate. *But more importantly*, in our experience investors are increasingly getting the terms they find more desirable as the fund industry continues to naturally mature.[124] We believe it is imprudent to intervene in a functioning, competitive market.

B. The Compliance Expense Rules

In addition to increases in insurance premiums, costs of contract negotiations, and operational challenges posed by more stringent, and unclear, compliance requirements, we believe the Proposed Rules introduce a degree of uncertainty in planning for a fund's future liquidity needs. It is probable that advisers will attempt to shift many of the increased costs and expenses resulting from the Compliance Expense Rules to investors through increases in the management fee, a rather blunt instrument for covering expenses that are mostly irregular.[125] To us, the relative infrequency and magnitude of expenses associated with examinations, investigations, and other compliance matters is incompatible with the regularity and magnitude of the management fee, but advisers will be left to account for these expenses through means other than a targeted single *pro rata* charge. As a result, advisers may self-insure and build their liquid holdings, an inefficient and comparatively unproductive use of capital. In any case, due to the unpredictability of these costs, advisers will either unintentionally and unknowingly charge a fee beyond the adviser's needs, or as a result of the already-existing

122. *See* 15 U.S.C. § 80a–17(h)–(i) (prohibiting disclaiming liability by "reason of willful misfeasance, bad faith, *gross* negligence, or reckless disregard" of the affiliates' duties and or obligations (emphasis added)).

123. *Compare id. with Proposed Rules*, 87 Fed. Reg. at 16,977 (to be codified at 17 C.F.R. § 275.211(h)(2)–1(a)(5)). *See also* Healthy Markets Ass'n, Comment Letter on the *Proposed Rules* at 2 (Apr. 15, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20123868-280038.pdf ("The Proposal seeks to reduce this gap in investor protections between public and private funds by essentially requiring greater information from, as well as prohibiting some activities by, private funds.").

124. *See* HEDGE FUND RSCH., *Microstructure Hedge Fund Industry Report Year End 2020* (2020), https://www.hfr.com/reports/market-microstructure (showing that management fees have decreased from 1.55% to 1.37% and carry has reduced from 19.3% to 16.4% since 2008); Ben Johnson & Gabrielle DiBenedetto, *2020 U.S. Fund Fee Study*, MORNINGSTAR 1 (Aug. 2021), https://www.morningstar.com/lp/annual-us-fund-fee-study (referencing mostly ETFs, "The average expense ratio paid by fund investors is half of what it was two decades ago.").

125. *Proposed Rules*, 87 Fed. Reg. at 16,948 ("For example, advisers may identify and implement methods of replacing the lost charges from the prohibited practice with the other sources of fund revenue.").

downward pressure on fees,[126] advisers may fail to charge a sufficient fee, resulting in liquidity and operational problems. In both cases, investors suffer.

From a different perspective, advisers create funds with a specific recipe to achieve a specific goal; most advisers have carefully balanced the economics of their investment products. Changing the recipe in the midst of a fund's lifecycle, especially parts affecting cash flow, unwisely alters the mechanics of the fund, and in some cases, could endanger it. We have no doubt that some funds will be able to bear the added expense and complexity, but for the smaller funds, it is less certain. We do not believe the Commission's actions promote efficiency, competition, or capital formation due to the increased uncertainty, expense, and burden the Proposed Rules seem likely to beget.

C. The Preferential Disclosure Rules

The Proposed Rules would prohibit providing only some investors in a fund with information on the fund's, or a substantially similar pool of assets', holdings or exposures, if the adviser reasonably expects that providing the information would have a material, negative effect on the uninformed investors in that private fund or in a substantially similar pool of assets (the "***Preferential Disclosure Rules***").[127] As with the Standard of Care Rules and Compliance Expense Rules, we believe, the Commission lacks sufficient statutory authority to promulgate and adopt the Preferential Disclosure Rules.[128] However, we also believe the Preferential Disclosure Rules have other flaws counseling against their adoption.

At the outset, it seems that in applying the Preferential Disclosure Rules, many advisers will be required to consider all investors in all of the adviser's funds, rather than just investors in a similar fund. We note the attempt to limit an adviser's consideration to investors in the private fund and to those in a "substantially similar pool of assets." But the latter encompasses any fund "with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons."[129] For the largest investment managers, some funds would be excluded to be sure, but for managers with a particular skillset or sector expertise, at what level of granularity are these characteristics determined? In some sense, all funds share the investment objective of seeking to generate "an attractive risk-adjusted return," or "alpha." At the other end of the spectrum, a fund's objective could be defined with reference to varyingly specific listings, formalistically phrased as seeking to generate "an attractive risk-adjusted return by investing in these

126. *See* Johnson, *supra* note 124, at 6 (again referencing mostly ETFs, "Low-cost funds generally have greater odds of surviving and outperforming their more-expensive peers. . . . During each of the past seven years, the most expensive 80% of active funds has accounted for all of the net outflows across all funds.").

127. *Proposed Rules*, 87 Fed. Reg. at 16,977 (to be codified at 17 C.F.R. § 275.211(h)(2)–3(a)(2)).

128. To be clear, we do not believe 15 U.S.C. § 80b–11(h)(1) provides authority because the Commission is not "facilitat[ing]" disclosure but is in fact prohibiting it. Likewise, we believe the Commission would not possess sufficient authority to interpret "sales practices, conflicts of interest, and compensation schemes" in such a way that the Preferential Disclosure Rules may be promulgated pursuant to the Commission's authority to prohibit or restrict the same. *See* 15 U.S.C. § 80b–1(h)(2); *supra* Part II.A.1. We also acknowledge that *Chevron* deference may not be afforded to the Proposed Rules, in which case we believe the Commission's authority to adopt the Preferential Disclosure Rules stands on even shakier ground. The Preferential Disclosure Rules may be invalidated as a result. *See supra* note 99 and accompanying text.

129. *Proposed Rules*, 87 Fed. Reg. at 16,976 (to be codified at 17 C.F.R. § 275.211(h)(1)).

specific [companies, sectors, regions of x, y, and/or z]," in which case there may be no other fund that is a substantially similar pool of assets.

Clearly, the Commission intends the demarcation to be at some point in the middle,[130] and even if the Commission tried to further delineate the point, it would "only push[] the problem back to the meaning of the defining terms."[131] In point of fact, a fund with "a materially different target return or sector focus, for example, would likely not have substantially similar investment policies, objectives, or strategies as the subject private fund, *depending on the facts and circumstances*."[132] While this clarification is helpful, it "only pushes the problem back to" what the other facts and circumstances are and how they should be weighted.

The problem of the rules' scope extends beyond this definition, however. If reference to "substantially similar pool of assets" was removed from the Preferential Disclosure Rules,[133] the prohibition would still cut too deep. We believe the most plausible reading of the Preferential Disclosure Rules prohibits far too many statements and conversations between an adviser and investor. For example, if an investor speaks with an employee of the adviser about the performance of the investor's account, the long-term prospects of the sector in which the fund invests, or even the general economic outlook, could each tête-à-tête not properly be classified as "provid[ing] information regarding portfolio holdings or exposures?"[134] We strain to see how they would not.

The Preferential Disclosure Rules have other problems in their reach. The rules would effectively prevent advisers from disclosing *any* information regarding holdings or exposures in a fund because it is unclear when information would have a "material, negative effect on other investors in that private fund or in a substantially similar pool of assets."[135] Reserving the question of materiality, itself a complicated analysis,[136] defining the prohibition's scope with respect to investors creates a riddle of compliance for advisers. The Preferential Disclosure Rules would effectively require advisers to provide all investors the exact same information, which facially appears innocuous. However, some investors currently receive more information because of the investor's legal obligations, such as a pension fund complying with its duties (fiduciary or otherwise) to its beneficiaries. If advisers must make the same disclosures to all investors, then it is possible that some parties could use the legally-required disclosures for pensions (or the otherwise uniform disclosures all investors would receive) to

130. *See infra* note 132.

131. *Goldstein*, 451 F.3d at 878 (citations omitted).

132. *Proposed Rules*, 87 Fed. Reg. at 16,929 (emphasis added).

133. In other words, the Preferential Disclosure Rules would read: "Provide information regarding the portfolio holdings or exposures of the private fund to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund."

134. *See infra* note 141 and accompanying text.

135. *Proposed Rules*, 87 Fed. Reg. at 16,977 (to be codified at 17 C.F.R. § 275.211(h)(2)–3(a)(2)) (emphasis denoting a defined term removed).

136. *See generally* Victor Brudney, *Note on Materiality and Soft Information under the Federal Securities Laws*, 75 VA. L. REV. 723, 724 (1989) (critiquing the Supreme Court's materiality doctrine in *Basic* as not "remov[ing] any of the brambles or to make the thicket more penetrable"); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976); Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 44 (2011) (stating that to be material, information must have "[s]omething more . . . not limited to statistical significance and can come from the source, content, and context of the reports" (internal quotation marks and citations omitted)).

the detriment of the fund itself, for example by front-running the fund.[137] As a result, an adviser is left with a riddle of competing regulatory obligations to its investors and the fund, with the solution apparently being fewer disclosures to all investors.

Complicating matters, an adviser must take into account many, if not all,[138] of its funds and underlying investors in deciding whether any investor will be materially and negatively affected if it does not receive the information. To do this, the adviser must first assess materiality by determining whether there is a substantial likelihood that a reasonable investor would view that information as altering the "total mix" of information available.[139] Or in plain English, the test seems to be whether an investor in any of the adviser's funds would find another of the adviser's fund's holdings relevant.[140] Considering the entire fund industry rests on the fact that investors find their adviser's holdings (indirectly, through their funds) incredibly relevant, it seems to necessarily follow that any disclosure "regarding the portfolio holdings or exposures" would necessarily be material. Even if most hedge funds do not provide position-level detail, the Preferential Disclosure Rules apply to any information "regarding" portfolio holdings. Based on the interpretation of "relating to"[141] in the context of the Books and Records Rule,[142] it seems that any discussion as to the fund's investments would be severely curtailed to all investors' detriment.

If the adviser determines the information is material, the adviser must then prognosticate as to whether other investors would be negatively affected if the disclosure is made only to a subset of investors. By way of illustration, the Proposed Rules provide examples of clear-cut cases with negative effects, but the cited examples would violate an adviser's fiduciary duties and be punishable under existing law. First, the Commission says, investors could front-run the fund, wherein the informed investor buys an asset before the fund does, leading the fund to pay a higher price and resulting in immediate gains for the tippee investor once the fund purchases the asset. Alternatively, the investor could avoid losses by redeeming its interest in the fund before other investors. We wholeheartedly agree neither of these situations should occur, but we do not believe any further regulation is needed to outlaw these practices.

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137. Of course, any such bad actor would be harming its own pecuniary interest, but a bad actor may view the fund's minimum investment as a small price to pay for the information it would receive.

138. *See supra* notes 129–134 and accompanying text.

139. *See supra* note 136. More broadly, if an investor outside the adviser's funds learned that a billion dollar hedge fund was buying or selling a stock, would that investor not find that fact as altering the "total mix" of information? *See generally* Charles Cao, Bing Liang, Andrew W. Lo, & Lubomir Petrasek, *Hedge Fund Holdings and Stock Market Efficiency*, 8 REV. OF ASSET PRICING STUD. 77 (2017) ("Our findings support the role of hedge funds as arbitrageurs who reduce mispricing in the market." *Id.* at 77.).

140. Whether "relevance" and "materiality" mean exactly the same thing is a question best explored in a law review article, but for the fund professionals who must use this standard, the terms are synonymous enough. *See* George S. Georgiev, *Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation*, 64 UCLA L. REV. 602, 617 (2017) ("Scholars and commentators have identified various problems relating to materiality, arguing that the standard is imprecise, that it is difficult for reporting firms, judges, and juries to work with . . . ." (footnote omitted)); *Basic*, 485 U.S. at 232 ("The application of this materiality standard to preliminary merger discussions is not self-evident."). The application here is not self-evident either, regardless of whatever definition the Commission might propose.

141. Thomas P. Lemke & Gerald T. Lins, REG. OF INV. ADV., § 2:57, n.5 ("The SEC staff broadly construes [17 C.F.R § 275.204–2(a)(7)] to include client communications about advice, as well as internal communications among adviser personnel about advice to be given to clients.").

142. 17 C.F.R § 275.204–2.

But beyond the advisability of new rules prohibiting already-prohibited conduct, the Preferential Disclosure Rules overestimate an adviser's ability to, as the rules put it, "reasonably expect[]" a negative future effect. Advance notice of information does not necessarily lead better outcomes for the better-informed. Demonstrating the point, a recent study analyzed the performance of a group of hackers who broke into the networks of major news wire services to gain advance information on earnings announcements, the very information materiality jurisprudence is built upon. Contrary to what one might expect, "their performance was surprisingly poor."[143] The hackers successfully identified the best trades only 30% of the time, "reflect[ing] the noisiness of earnings announcements as a predictor of stock price responses," or put another way, it is very difficult to predict how others will react to information, even if you know the information is incredibly material.[144] There will be cases the effect will be clear—we think those are already illegal—but for nearly every other case, it is impracticable to have an idea *ex ante* as to what effects are reasonable to expect.

Out of advisers' fear of non-compliance, the Preferential Disclosure Rules would result in drastically less contact between investors and their advisers, as well as reduced disclosures, regardless of whether the foregone disclosures would actually result in a material, negative effect on other investors. We believe that this outcome would in some cases impair the adviser's ability to meet its investors' goals, as well as the adviser's ability to comply with its other regulatory obligations.[145]

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We appreciate the Commission's considered attention to our comments, and we stand ready to discuss the Proposed Rules and above issues should the Commission wish to do so. Please direct any such questions or requests to Evan K. Hall [redacted] or Kit Addleman [redacted]

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143. Chloe Xie, *The Signal Quality of Earnings Announcements: Evidence from an Informed Trading Cartel* 23 (Stan. Bus. Sch. Working Paper, Nov. 19, 2019), https://api.semanticscholar.org/CorpusID:208029692. Although the hackers were profitable, this is mostly attributable to the large sample of trades they executed.

144. *Id.*

145. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248, 84 Fed. Reg. 33,669, 33,672–74 (July 12, 2019) (stating advisers must, as a result of their fiduciary duties, provide investment advice that is in the best interest of the client, including a duty to provide suitable advice). Of course, advisers to private funds comply with this "best interest" requirement through adherence to the funds' stated objectives, *id.* at 33,673, but given that investors often invest in other of the adviser's products, we believe the chilling of any contact between adviser and investor would diminish the adviser's ability to recommend appropriate products to the investor. *See id.* at 33,674 n.42.