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April 25, 2022

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

Submitted via email (rule-comments@sec.gov)

Re: Proposed Rules and Rule Amendments Regarding Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews [Release No. IA-5955; File No. S7-03-22]

Dear Ms. Countryman:

This letter is submitted by Akin Gump Strauss Hauer & Feld LLP, an international law firm with a significant investment management practice that, among other things, represents registered investment advisers, exempt reporting advisers, and other entities that advise and manage private funds. Within this practice, we maintain a specialty in representing investment advisers that utilize systematic and quantitative investment tools, as well as artificial intelligence and machine learning systems (collectively, "Quant Managers").

This comment letter provides certain comments and views regarding the impact that proposed Rule 211(h)(2)-1 (the "Proposed Rule"), which was proposed by the U.S. Securities and Exchange Commission (the "Commission") in Investment Advisers Act Release No. IA-5955[1] (the "Release"), would have on investment advisers, including Quant Managers, and their clients. For the sake of clarity, we point out that this comment letter represents the views of members of the firm who advise private funds, and are not intended to reflect the views of any particular firm client or group of clients.

We appreciate the Commission providing us the ability to provide comments on the Proposed Rule and recognize the time and effort invested by the Commission and the Staff of the Division of Investment Management (the "Staff") in formulating the Proposed Rule and in the drafting the Release.

BACKGROUND

On February 9, 2022, the Commission released the Proposed Rule in the context of a broader circulation of proposed rules and rule amendments contained within the Release. The Proposed Rule would

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955 (Feb. 9, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-5955.pdf.

provide, among other things, for the following new regulation to govern the relationship between investment advisers (including Quant Managers) and their clients:

> An investment adviser to a private fund may not, directly or indirectly, … [s]eek 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[.]

In the Release, the Commission indicates that one impetus for this proposal is that the Staff "has observed private fund agreements with waiver and indemnification provisions that have become more aggressive over time" and that the Commission is concerned that "[w]hile these contractual terms may be permissible under certain state laws, a waiver of an adviser's compliance with its Federal antifraud liability for breach of fiduciary duty to the private fund or with any other provision of the Advisers Act or rules thereunder is invalid[.]"

The Release also states that the Commission believes that this prohibition 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). By limiting an adviser's responsibility for breaching the standard of conduct, the incentive to comply with the required standard of conduct is eroded. We believe such contractual provisions are neither in the public interest nor consistent with the protection of investors, particularly where investors are led to believe the adviser is contractually not obligated to comply with certain provisions of the Act or rules thereunder, or where investors with less bargaining power are forced to bear the brunt of such arrangements.

We understand that the Commission is receiving numerous comment letters that address the inconsistency of the Proposed Rule with the 2019 "Fiduciary Interpretation,"[2] and others that question the Commission's authority to promulgate the Proposed Rule under existing law. We will not address those points in this letter, but will instead focus on certain unintended practical – and adverse – impacts of the Proposed Rule on investment advisers, particularly on Quant Managers and investors in the private funds they advise.

COMMENTS

As a general matter, we believe that the Proposed Rule, as well-intended as it may be, will dramatically change the allocation of liability between investment advisers and their private fund clients (and, derivatively, the investors in those funds), which will ultimately be to the detriment of the retirement plans, institutions, and other sophisticated investors that utilize private funds to meet their financial goals and obligations. We understand and expect that the Commission has received and will receive comment letters that address this overall point in a fulsome way, and we will not seek to make those general arguments

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[2] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Release No. IA-5248 (June 5, 2019).

in this letter. We would, however, like to provide a specific example of how investment advisers and investors who utilize a particular strategy will be disadvantaged by the Proposed Rule.

If the Proposed Rule is adopted, investment advisers who specialize in systematic and quantitative investment strategies (i.e., Quant Managers) and their private fund clients will experience a seismic shift in the historical allocation of liability for strategy-related exceptions and errors that do not constitute gross negligence or willful misconduct. This will upset a delicate balance of responsibility that has evolved over time to meet the challenges posed by this unique investment strategy. Changing this agreed-upon allocation of responsibility will, we firmly believe, result in lower strategy diversification and, perhaps, lower risk-adjusted returns over time for retirement plans, institutions, and other sophisticated investors.

As the Staff knows, private funds advised and managed by Quant Managers commonly employ a "gross negligence" standard of liability for the adviser. In other words, if there is an error or exception in a Quant Manager's algorithm, program, or system, the resulting losses will be borne by the Quant Manager if they resulted from the Quant Manager's gross negligence or willful misconduct (losses resulting from lesser mental states generally are borne by the private fund). The Commission has not, as far as we can tell, faced difficulties in bringing enforcement actions against Quant Managers under the current market standards.[3]

This arrangement is generally expressed in exculpatory language stating that the adviser "will not be liable to the private fund for any act or omission, absent the fraud, gross negligence or intentional misconduct" of the Quant Manager and its supervised persons, and an additional provision stating that the private fund will generally be required "to indemnify the adviser against any losses they may incur by reason of any act or omission related to the private fund, absent any fraud, gross negligence or intentional misconduct" of the Quant Manager and its supervised persons.

This limitation of liability is generally prominently disclosed to investors and often is accompanied by additional explanations and risk factors related to the possibility of loss – in other words, this arrangement, which is the result of an enforceable contract entered into by willing, and sophisticated, participants, should be respected and left unmolested by the Commission.

However, the Commission should also withdraw the Proposed Rule for practical reasons: The gross negligence standard is appropriate to the risks inherent in the development and operation of a quantitative or systematic trading system. Indeed, it embodies a thoughtful, fair and balanced allocations of those risks. To alter this balance will inevitably result in what will be, in effect, a strict liability system and every Quant Manager may, literally, be one keystroke error away from going out of business.

[3] *E.g.*, In the Matter of AEGON USA Investment Management, LLC, *et al.*, Release No. IA-3149 (Aug. 27, 2018); In the Matter of AXA Rosenberg Group LLC, *et al.*, Release No. IA-3149 (February 3, 2011).

The Commission may well ask whether and how Quant Managers are different from other advisers. The answer is that they differ from other advisers in some ways, but are similar or identical in many others.

The development of quantitative and systematic investing systems is complex and often involves financial, economic, econometric and statistical theories, research, and modelling, which are then translated into computer code. This means that every quantitative or systematic investment program is at risk of errors of implementation (e.g., "bugs" and classic coding errors), errors of design, and errors resulting from the unexpected interaction of various code modules or systems with each other. These risks exist and persist notwithstanding diligent quality control, testing, and review processes (as well close monitoring and supervision of the systems' implementation). Similar risks exist with respect to the use of electronic and other networked systems, hardware and hardware failures, and third party data and service providers, all of which are incorporated into quantitative and systematic trading and investment strategies.

Quant Managers, importantly, disclose these risks. For their part, investors who seek to profit from the investing and trading programs that Quant Managers offer understand these risks, and their inherent nature, and recognize that the standard of liability for a Quant Manager must be higher than ordinary negligence or strict liability. These investors also recognize and acknowledge that requiring a standard lower than gross negligence likely would result in fewer managers offering quantitative and systematic strategies, in managers being undercapitalized, or in a significantly high risk of funds being "orphaned" after any error of any magnitude. In short, it is no understatement to assert that adoption of the Proposed Rule will result in fewer Quant Managers, which will be to the detriment of pension funds, institutions, and other investors that have deemed these investment strategies to be an essential part of their portfolio.

We also point out that a gross negligence standard of care in this context does not pose the concerns expressed in the Proposing Release:

- The application of a gross negligence standard in this context does not place the adviser's interests above those of its private fund clients; rather, this presents an intelligent risk allocation in a particular type of investment strategy.

- A gross negligence standard does not reduce a Quant Manager's responsibility for breaching its standard of conduct, and does not provide any incentive to not comply with the required standard of conduct. Rather, investors have agreed to an objective standard of care that is appropriate to a specific type of investment strategy.

- This standard is both in the public interest and is consistent with the protection of investors; there is no deceit or obfuscation on what a Quant Manager's liability is, or how it is measured. There generally is, rather, an increased amount of disclosure on the risks involved and the ramifications for unforeseen adverse events.

Finally, we want to be clear that, by highlighting the impact of the Proposed Rule on Quant Managers, we are not implying the Proposed Rule's adverse impact is limited to one subgroup of investment advisers.

Our firm's comment and recommendation is that the Proposed Rule, in its entirety, not be adopted by the Commission.

CONCLUSION

We would close by again thanking the Commission and the Staff for its strenuous and serious efforts to protect investors, and for doing so in a transparent and responsible manner. We would hope and expect that, after reflecting on the points raised in this comment letter, the Commission will conclude that the Proposed Rule is not necessary and, indeed, would be counterproductive and harmful to the industry in general and to investors in quantitative and systematic funds in particular.

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We would be pleased to respond to any inquiries you may have regarding our letter or our views on the Proposed Rule more generally. Please feel free to direct any inquiries to Brian Daly at +1 [redacted] or at [redacted].

Very Truly Yours,

AKIN GUMP STRAUSS HAUER & FELD LLP