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April 25, 2022

Via Electronic Submission

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

Re: Notice of Proposed Rulemaking: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (File No. S7-03-22)

Dear Ms. Countryman:

We appreciate the opportunity to provide comments to the Securities and Exchange Commission (the "SEC") on the SEC's recent proposal regarding certain rules governing private fund advisers (the "Proposed Rules").[1]

I. Introduction

This letter is written on behalf of clients and affected firms that manage in the aggregate more than $150 billion of investment capital for many of the world's most sophisticated institutional investors, including public and corporate pension funds, research institutions, health care providers, endowments and foundations. This letter focuses on a single issue of paramount importance to those firms and to their respective investors: the Proposed Rules' prohibition on allowing advisers to have private client funds pay directly, or reimburse

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16886 (March 24, 2022).

the adviser on an actual cost basis for, the cost of certain services the adviser[2] provides to the fund.

Our clients appreciate and support the SEC's goals of increasing transparency as well as competition and efficiency in the market. However, our clients believe these proposed prohibitions on passing certain actual costs through to investment funds would be counterproductive to those objectives. Such an actual cost expense structure has long been used by a number of extremely well-performing private funds that see consistently high demand from some of the most discriminating and sophisticated institutional investors. In an actual cost expense structure, the fund (and, indirectly, its investors) pays for costs actually incurred, rather than relying solely on an asset-based management fee to cover costs that often reflects an imprecise advance estimate of such costs. The adviser also receives a standard performance fee, subject to a high water mark. An actual cost structure is often a particularly good fit for multi-strategy firms and their clients. Such firms, which pursue a broad range of investment strategies across a variety of asset classes and geographies, must be prepared to adjust nimbly to changing market conditions and investment opportunities, which means continually reassessing optimal resource deployment in areas such as information technology and systems infrastructure as well as compliance support. An actual cost expense structure allows an adviser to dynamically calibrate resource deployment in a manner the adviser believes is in the best interests of a given fund, which enables the adviser to meet its fiduciary duties. By contrast, an adviser without an actual cost expense structure may be disincentivized, or simply unable to, make these sorts of investments or calibrations if the adviser's cost budget and, as a result, infrastructure, technology and compliance spend, are in many respects fixed.

Our clients firmly believe that the Proposed Rules' prohibition on an adviser's ability to use actual cost expense structures in relation to certain categories of expenses would fail to serve the SEC's core mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation. To the contrary, the prohibition would limit the ability of sophisticated investors, capable of evaluating the effects of a variety of cost structures and giving fully informed consent, to choose a particular fee and cost structure, despite that structure being fairly disclosed. In addition, the prohibition dismisses the view that actual cost structures may achieve more effective alignment of interests between investors and the advisers to which they allocate capital because actual cost advisers are more directly compensated based on performance. The prohibition would undoubtedly also have other adverse, presumably unintended, consequences described below. Further, it is highly questionable whether the SEC's statutory authority extends as far as the prohibition, or whether the prohibition's costs and benefits have been analyzed to the extent legally required. Our clients urge the SEC to avert needless harms to sophisticated investors and managers by declining to adopt the proposed restrictions.

[2] References to services provided by an adviser to a fund includes services provided by entities affiliated with the adviser.

The Proposed Rules would, among other things, prohibit an adviser to a private fund from being reimbursed[3] by the fund on an actual cost basis for certain fees and expenses related to regulatory and compliance matters, including (1) those associated with an examination or investigation of the adviser or its related persons by a governmental or regulatory authority and (2) regulatory and compliance fees and expenses of the adviser or its related persons.[4] This prohibition, which we refer to as the "Cost Reimbursement Prohibition," would apply flatly, without exception, and regardless of any other relevant considerations, including the extent and quality of the adviser's disclosure, the adviser's investment strategy and the sophistication of the investors. As the Proposed Rules note, certain private fund advisers, which we refer to as "Actual Cost Advisers," "utilize a pass-through expense model where the private fund pays for most, if not all, expenses, including the adviser's expenses."[5] The Proposed Rules suggest that the Cost Reimbursement Prohibition, if implemented, "would likely require advisers that pass on the types of fees and expenses [the SEC] propose[s] to prohibit to re-structure their fee and expense model."[6]

The Cost Reimbursement Prohibition would prohibit elements of a long-established fee and expense model that both sophisticated investors and advisers have embraced. The Proposed Rules contain only cursory discussion and analysis of the Cost Reimbursement Prohibition and also fail to articulate the nature and magnitude of the prohibition's expected benefits or to whom they would theoretically inure, or demonstrate that such speculative and hypothetical benefits would outweigh the more easily foreseeable costs. These issues, plus a short comment period at a time when numerous other critical SEC proposals are also out for comment, all show that the Proposed Rules are vulnerable to legal challenge.[7]

Below, we identify and describe in more detail key concerns with the process and substance of the proposed Cost Reimbursement Prohibition. These concerns are deeply interwoven, but for purposes of this letter, we have grouped them into three categories:

> **Authority** – the statutory authority, or lack thereof, for the Cost Reimbursement Prohibition;

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[3] Actual cost expense structures may involve payment of expenses directly by the fund and/or payment of expenses by the adviser, with the adviser then reimbursed by the fund for the actual cost incurred. Both methods achieve the same result and both would face restrictions under the Proposed Rules. In this letter, we may refer to such a structure as a "pass through" model, an "actual cost expense" model or a "cost reimbursement" model interchangeably.

[4] 87 Fed. Reg. at 16922.

[5] Id. at 16922 n.157.

[6] Id.

[7] See Letter to Hon. Gary Gensler from Joint Trade Associations, dated April 5, 2022, *available at* https://business.cch.com/srd/SIFMAalongwithotherassociationssubmittedajointassociationlettertotheSECRegardingtheNeedforSufficientCommentPeriods.pdf.

Process – the arbitrary and capricious nature of the proposed SEC action; the lack of presentation or analysis by the SEC of current market practices or the projected costs and benefits of the Cost Reimbursement Prohibition; and the limited time for market participants to review, analyze and comment on the Cost Reimbursement Prohibition; and

Analytic Substance – the failure to consider: (1) empirical evidence (in a highly competitive market with thousands of managers,[8] sophisticated parties have chosen an actual cost, pass-through model as a preferred feature of their investor-adviser relationship) and (2) relevant theories of alignment of interests in principal-agent relationships, which can show that direct pass through of actual costs is better for both parties than when an agent is forced to estimate future costs.

II. Authority

The Cost Reimbursement Prohibition appears to exceed the SEC's statutory authority.

In claiming that the cost reimbursement practices at issue "create an incentive for an adviser to place its own interests ahead of the private fund's interests," the Proposed Rules invoke the concept of conflict of interest.[9] The Investment Advisers Act of 1940 (the "Advisers Act"), the source of the SEC's power to regulate investment advisers, gives to the SEC the authority to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes. . . that the [SEC] deems contrary to the public interest and the protection of investors."[10] The Cost Reimbursement Prohibition purports to rely upon this authority. However, the Proposed Rules are vague about how an expense structure that is disclosed to sophisticated investors with significant experience and negotiating power—and that, indeed, investors have embraced as a means to align their advisers' incentives with their own—raises a conflict of interest, let alone one that is intrinsically "contrary to the protection of investors." The Proposed Rules present no evidence that actual cost expense structures give rise to conflicts of interest and appear not to consider the fact that expenses paid by a fund in almost all cases reduce any performance fee due to the adviser, meaning that in practice the adviser already economically bears a significant percentage of the expenses. In addition, when partners and employees of an Actual Cost Adviser invest in one of the adviser's funds alongside external investors, which is common among the Actual Cost Adviser's on whose behalf we submit this letter, they bear a proportionate share of the Actual Cost Adviser's expenses, which further aligns interests. Conversely, when an adviser charges only a management fee to a fund, the adviser may waive that management fee for the share class in which partners and employees invest, meaning that these insider investors effectively pay lower expenses. Absent an

[8] According to the Proposed Rules, 5,139 registered investment advisers and 4,900 exempt reporting advisers reported on Form ADV that they are advisers to private funds. 87 Fed. Reg. at 16935.

[9] 87 Fed. Reg. at 16922.

[10] 15 U.S.C. § 80b-11(h).

articulation of how actual cost expense structures give rise to a conflict of interest, the Cost Reimbursement Prohibition lacks clear grounding in its stated statutory authority.[11]

In any case, the SEC's authority to regulate purported conflicts of interest is premised on there being a demonstrable link between those conflicts and the Advisers Act's goal of "prevent[ing]. . . course[s] of business [that are] fraudulent, deceptive, or manipulative."[12] The SEC does not have a free hand to classify well-understood cost structures as "conflicts of interest" based on a definition of that term that does not link back to the Advisers Act's core anti-fraud purposes. Viewed in this light, the statutory basis for the Cost Reimbursement Prohibition is conspicuously thin. Given the Proposed Rules' failure to show, or even plausibly argue, that the Cost Reimbursement Prohibition bears a reasonable relationship to preventing fraud, deception or manipulation, our clients do not believe the Cost Reimbursement Prohibition is within the SEC's authority to promulgate under the Advisers Act. As the U.S. Supreme Court has held, to achieve the Advisers Act's goal of "avoiding frauds," the statute must be "construed . . . flexibly to effectuate its remedial purposes."[13] But flexible does not mean unbounded. To the contrary, the Advisers Act permits the SEC only to "prescribe means *reasonably* designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[14] The SEC has also recently said, in summarizing what has long been understood to be the law, that "[t]he fiduciary duty [of an investment adviser] follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."[15]

It is also worth noting that the private funds at issue here, which are owned exclusively by sophisticated investors, are specifically excluded from the definition of "investment company" under the Investment Company Act of 1940 (the "Investment Company Act"), a regime of prescriptive rules designed to protect retail investors. It has long been accepted that investment vehicles owned by sophisticated investors, versus those owned by retail investors, raise different considerations and should not be subject to the same regulatory regimes. Indeed, the SEC itself recommended 25 years ago that Congress exclude funds "owned exclusively by sophisticated investors" from registration under the Investment Company Act.[16] Accepting the SEC's recommendation, Congress enacted the 3(c)(7) exemption to the

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[11] The claim in the Proposed Rules that certain cost reimbursement practices create a conflict of interest may be the result of misconceptions regarding how actual cost expense structures operate. It is challenging to identify the misconceptions that may exist given the Proposed Rules' paucity of discussion or explanation on this point.

[12] 15 U.S.C. § 80b-6(4).

[13] S.E.C. v. Capital Gains Research Bureau, Inc., et al., 375 U.S. 180, 195 (1963).

[14] 15 U.S.C. § 80b-6(4) (emphasis added).

[15] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669, 33671 (July 12, 2019).

[16] Private Investment Companies, 61 Fed. Reg. 68100, 68101 (proposed Dec. 26, 1996) (codified at 17 CFR 270.2a51–1, .2a51–2, .2a51–3, .3c–1, .3c–5 and .3c–6).

Investment Company Act, recognizing "the important role that these [investment vehicles] can play in facilitating capital formation for U.S. companies"[17] without posing undue risk to investors, as "sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections."[18] The Cost Reimbursement Prohibition is, on its face, inconsistent with Congress's treatment of sophisticated investors in the Investment Company Act, where Congress recognized that sophisticated investors in private funds are capable of "evaluat[ing] on their own behalf" the risks and benefits of a particular investment, including associated fees.[19]

The Cost Reimbursement Prohibition is not consistent with any of these authorities nor does it make any real effort to engage with them. Rather, the Proposed Rules simply state that for a private fund to bear the expenses prohibited by the Cost Reimbursement Prohibition would be inherently "deceptive and result in obscured payments . . . even if disclosed and governed."[20] This statement assumes its own conclusion. There should be—as there has historically been—a strong presumption that sophisticated institutional investors are capable of choosing to invest in a private fund after receiving disclosure of its expense terms, in which case such investors cannot have been deceived.[21] Finally, in the phrase "disclosed and governed," one must logically read "disclosed" as "fully and fairly disclosed"; materially incomplete or misleading disclosure is already prohibited on numerous grounds. But to say that a payment may

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[17] H.R. Rep. No. 104-622, at 18 (1996); S. Rep. No. 104-293, at 10 (1996).

[18] S. Rep. No. 104-293, at 10 (1996).

[19] Id.

[20] 87 Fed. Reg. at 16959.

[21] The SEC has adopted numerous rules on the basis that sophisticated investors are capable of making their own investment decisions after receiving full and fair disclosure. For example, the Advisers Act's restriction on investment advisers charging clients performance or incentive fees does not apply to investment advisory contracts with issuers exempt from the Investment Company Act pursuant to Section 3(c)(7) (i.e., issuers whose outstanding securities are owned by qualified purchasers) or to investment advisory contracts with qualified clients (which includes individuals or institutional investors that have at least $1.1 million in assets under the management of the investment adviser, a net worth of more than $2.2 million or are "qualified purchasers" as defined in the Investment Company Act). See 15 U.S.C. § 80b-5(a)(1); 15 U.S.C. § 80b-5(b)(4); 17 C.F.R. § 275.205-3; Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Advisers Act Release No. 5756 (June 17, 2021). In issuing its rule exempting advisory contracts with qualified clients from the restriction, the SEC acknowledged that it was seeking to "provide investment advisers greater flexibility in structuring performance fee arrangements with clients who are financially sophisticated or have the resources to obtain sophisticated financial advice regarding the terms of these arrangements." Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, 63 Fed. Reg. 39022 (July 21, 1998). The SEC emphasized that the exemption did "not alter the obligation of an adviser, as a fiduciary, to deal fairly with its clients and to make full and fair disclosure of its compensation arrangements," with such obligation to include "full client disclosure of all material information regarding a proposed performance fee arrangement as well as any material conflicts posed by the arrangement." Id. at 39023–24. The analysis with respect to allowing investment advisers to enter into advisory contracts with sophisticated investors that charge performance or incentive fees and with respect to allowing investment advisers to enter into actual cost expense structures with sophisticated investors is essentially the same.

be both "fully and fairly disclosed" and "obscured" is a contradiction. To make this observation is not merely to take issue with choices of wording but to point out that the Cost Reimbursement Prohibition cannot be said to be reasonably designed if it rests on such a contradiction.

III. Process

The Proposed Rules would constitute arbitrary and capricious agency action, lack presentation or analysis by the SEC of current market practices or the projected costs and benefits of the Cost Reimbursement Prohibition and provide limited time for market participants to review, analyze and comment on the Cost Reimbursement Prohibition.

Even if the Proposed Rules were determined to be otherwise consistent with the authority granted to the SEC pursuant to the Advisers Act, adoption would be an arbitrary and capricious agency action. Despite the SEC's statutory obligation to conduct a thorough economic analysis of the market impact of a new rule, the Proposed Rules' consideration of the costs and benefits of the Cost Reimbursement Prohibition is superficial and conclusory. The SEC has not studied the asset management market to articulate the nature and magnitude of the expected benefits of the Cost Reimbursement Prohibition, let alone demonstrate that these benefits outweigh expected costs. In the case of the Cost Reimbursement Prohibition, significant costs would be borne disproportionately by the Actual Cost Advisers (and their investors) in the market. Finally, the Proposed Rules artificially segregate interconnected issues, including with respect to new SEC proposed rules concerning disclosures, recordkeeping, and activity restrictions, into separate, non-contemporaneous proposals, some of which are yet to come, making full engagement with market participants on all issues in an abbreviated comment period virtually impossible.[22] Market participants cannot, nor should the SEC, consider the costs and benefits of each proposal in isolation.

A thoughtful cost-benefit analysis would require an investigation into the asset management market generally, and particularly with respect to Actual Cost Advisers and their investors, to garner understanding of the economic benefits and alignment of incentives that result in many sophisticated investors choosing to invest with Actual Cost Advisers. The comment period for these Proposed Rules should have been preceded by market study consistent with the SEC's past practice, including roundtables, data gathering, reports and opportunity for all interested parties to have access to and engage with the SEC staff before the Proposed Rules' issuance. Proposed rules with the potential for significant market impact should not be drafted in a vacuum. Further, when limited analysis or data is provided with a proposal, an unfair burden is placed on the public's right to participate in a meaningful notice-and-comment process, which is not in keeping with the Administrative Procedure Act.[23] Our clients believe that a conscientious evaluation would lead to the conclusion that the Cost Reimbursement Prohibition is unnecessary.

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[22] The Proposed Rules were issued publicly on February 9, 2022 and were published in the Federal Register on March 24, 2022. As a result, the comment deadline is April 25, 2022, the first business day after the thirtieth day following the Proposed Rules' publication in the Federal Register.

[23] The burden to the public of issuing a rule proposal without sufficient data or analysis is amplified when market participants are given insufficient time to consider a proposal, gather data, and articulate their views, particularly

As noted above, the Advisers Act authorizes the SEC to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes. . . that the [SEC] deems contrary to the public interest and the protection of investors."[24] The Proposed Rules purport to deploy this statutory authority by categorizing disclosure transparency and conflict of interest concerns as either "can be managed" or "cannot be managed."[25] The Proposed Rules provide no basis for the assertion that an element of the investor-adviser relationship that is fully and fairly disclosed to sophisticated investors could raise a conflict of interest issue that is necessarily "contrary to the protection of investors."[26]

Finally, adopting the Cost Reimbursement Prohibition in its current form would be intrinsically premature. If other proposals in the Proposed Rules are adopted, regulators and market participants will need time and experience with the resulting changes to assess, first, whether the enhancements have been generally effective and, second, whether additional proscriptions such as the Cost Reimbursement Prohibition are warranted or, conversely, are reasonably demonstrated to be unnecessary.

IV. Analytic Substance

The Proposed Rules fail to consider: (1) empirical evidence (in a highly competitive market with thousands of managers, sophisticated parties have chosen an actual cost, pass-through model as a preferred feature of their investor-adviser relationship) and (2) relevant

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where complex financial issues are at play. The Proposed Rules' abbreviated 30-day comment period did not provide a meaningful opportunity to comment, particularly in light of the complex and multifaceted financial issues at hand and the difficulty for commentators in obtaining relevant data within this short time frame. Although no length of comment period can cure a flawed process, a 30-day comment period is facially deficient.

[24] 15 U.S.C. § 80b-11(h)(2).

[25] 87 Fed. Reg. at 16889.

[26] Further, there is no basis in the Proposed Rules for the dichotomy between conflict of interest concerns that "can be managed" versus those that "cannot be managed"—it is simply assumed—and it is inconsistent with market reality and economic theory. Even if one puts this process violation to the side, and without conceding that this dichotomy is appropriate, there must be a high bar for placing a practice into the "cannot be managed" category. A "cannot be managed" practice is one to which, by definition, even the most sophisticated institutional investors, with significant experience and negotiating power, are deemed to be unable to give informed consent even with full and fair disclosure. On the other hand, "can be managed" practices, the Proposed Rules suggest, are ones that, so managed—generally through greater disclosure and controls—may "help investors" and lead to "[m]ore competition and transparency" and "greater efficiencies [in the private funds] part of the capital markets." 87 Fed. Reg. at 16888–89. The Proposed Rules offer no evidence that an Actual Cost Adviser's passing through expenses to a private fund, including those prohibited by the Cost Reimbursement Prohibition, is a "cannot be managed" practice. If anything, the Proposed Rules broadly affirm the importance of disclosure in the context of investors' understanding of private funds' fee and expense structures. Qualitatively, the passing through of actual expenses is much closer to the practices that the Proposed Rules deem permissible with appropriate disclosure and controls than to the other practices that the Proposed Rules would proscribe. It must also be questioned why "cannot be managed" practices should be forbidden in this context, with highly sophisticated investors, while they are permitted in other contexts with less sophisticated investors, which might be the case in certain circumstances for registered funds, for example.

theories of alignment of interests in principal-agent relationships, which can show that direct pass through of actual costs is better for both parties than when an agent is forced to estimate future costs.

The Cost Reimbursement Prohibition would prohibit an adviser to a private fund from being reimbursed on an actual cost basis by the fund for regulatory and compliance fees and expenses of the adviser or its related persons. In proposing this restriction, the Proposed Rules do not consider that actual cost expense structures are often used by multi-strategy fund advisers that pursue a broad range of investment strategies across a variety of asset classes and geographies, as compared to private funds with more limited mandates. For such multi-strategy firms, the rationale for the actual cost expense structure is particularly compelling. The complexity and scale of the investment strategies pursued by multi-strategy fund advisers makes it critical that such advisers have the flexibility to pursue new strategies, asset classes and geographies to maximize investor returns as market conditions change. Such advisers should not face disincentives from incurring the regulatory and compliance costs associated with such changes. The actual cost expense model has served investors well over a long period of time and has enabled those multi-strategy firms utilizing the actual cost expense structure to ensure the resources dedicated to compliance functions match the size and scope of the business over time.

The Proposed Rules also fail to recognize that Actual Cost Advisers contribute to the diversity of fund fee and expense structures within the private fund ecosystem and thus to investor choice and competition. A fund investor may reasonably conclude, for example, that an Actual Cost Adviser that is reimbursed for actual compliance expenses by the fund is better incentivized to maintain compliance budgets at appropriate levels in a manner that is more aligned with investors' interests.[27] The Cost Reimbursement Prohibition could raise barriers to entry, reduce investor choice and curb a structure of the principal-agent relationship to which many sophisticated investors—in a competitive market with compressing fees and no shortage of private fund options—desire access. This restriction on the ability of sophisticated investors to choose the expense model they believe best positions an adviser to generate attractive returns should be taken into account. The Proposed Rules fail to recognize that these investors are sophisticated, are able to make informed decisions regarding the contours of their relationships with their advisers, and hold significant bargaining power.[28] Moreover, the Proposed Rules also fail to recognize that many (if not all) funds with this actual expense structure are open-ended funds, which means that investors generally have the ability to redeem capital over a disclosed

[27] See, e.g., Andrew Weiss, *Would Hedge Fund Investors Benefit From Paying Operating Expenses?*, 13 J. of Investing 91 (2004). Weiss gives the following example: assume an Actual Cost Adviser and a "management fee adviser" participate in 20% of a fund's profits. Assume that both advisers are faced with an opportunity that has an expected expense of $1 million per year and an expected benefit of $2 million per year. The Actual Cost Adviser is incentivized to pursue the opportunity. Fund profits are increased by a net of $1 million and the adviser receives additional income of $200,000. The "management fee adviser," however, will be incentivized to decline the opportunity. Although the fund stands to gain $2 million, the adviser's participation is only $400,000, while the expense to the adviser is $1 million, a net loss to the adviser of $600,000.

[28] Evidence of that bargaining power is data demonstrating that average adviser fees have been declining over time, as cited in the Proposed Rules. 87 Fed. Reg. at 16940, n.265.

and agreed period of time if they believe the expense model no longer achieves a desired alignment with their interests.

In addition, as acknowledged by the SEC in the Proposed Rules, it may not be clear in all cases whether certain fees and expenses relate to a fund or its adviser. The Cost Reimbursement Prohibition would prohibit passing through the adviser's actual compliance costs to the fund. The Proposed Rules' call for this allocation of compliance costs to be done merely "in a manner that [the adviser] believes in good faith is fair and equitable and is consistent with [the adviser's] fiduciary duty"[29] does not provide adequately specific guidance to advisers and leaves advisers susceptible to exposure and second-guessing by the SEC and investors.[30] Everything an adviser does should, in principle, be fair, equitable and consistent with its fiduciary duties; that the Proposed Rules provide no more guidance on this subject is perhaps an indication of how little analysis of the practical ramifications of adopting the Cost Reimbursement Prohibition has been undertaken. If the Cost Reimbursement Prohibition is adopted, the SEC should confirm that it will be construed narrowly in order to provide guidance to market participants.

The Proposed Rules also do not consider the potential impact that the Cost Reimbursement Prohibition could have by creating an economic disincentive for advisers with respect to the amount of resources they choose to allocate to compliance. Of course, our clients acknowledge that regardless of the outcome of the Proposed Rules, investment advisers do and should be expected to allocate sufficient resources to comply with applicable law and their fiduciary obligations to clients. As the SEC is aware, however, decisions about allocating resources are rarely a bright line test or matter of objective legal necessity; instead, they reflect a balancing of business interests (including those of clients), regulatory considerations and client expectations. The Cost Reimbursement Prohibition will undoubtedly affect those considerations. The Proposed Rules, however, do not address this potential unintended consequence or acknowledge the benefit to investors that can arise from agreeing to pay certain regulatory or compliance costs.

The articulated rationale for the Cost Reimbursement Prohibition assumes a static environment, but that will not be consistent with reality. If the Cost Reimbursement Prohibition is adopted, Actual Cost Advisers will likely negotiate a new fixed management fee, which would estimate the regulatory and compliance expenses—which are variable and inherently unpredictable—that the advisers could no longer pass through on an actual cost basis. While speculating that the Cost Reimbursement Prohibition would result in lower fees and increased

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[29] See 87 Fed. Reg. at 16922–23.

[30] Further, the distinction between "fund costs" and "adviser costs" is a less relevant distinction for Actual Cost Advisers, as Actual Cost Advisers are typically reimbursed for all of their costs and expenses other than those costs and expenses that are entirely unrelated to the services provided by such advisers. This includes all costs and expenses that would commonly be considered overhead or operating costs of the adviser, which are clearly related to the services provided by the adviser to the funds. The SEC's desire to label an adviser's services as either related or unrelated to the services it provides to the funds is a false dichotomy. Compliance and regulatory costs and costs associated with regulatory examinations and inquiries are simply another set of costs directly related to managing private funds.

investor returns, the Proposed Rules simultaneously acknowledge such a likely increase in fixed fees.[31] Additionally, the Proposed Rules provide no reasoned explanation as to why one expense model, which inherently must allocate estimated overhead and operating costs, should be considered acceptable, and the other, that allocates actual overhead and operating costs, should not, if all parties expect investors to be ultimately responsible for the same expense types under both structures as a practical matter. Further, a new (or increased) management fee might well exceed the amount that fund investors would have borne if they had been allowed to reimburse the adviser for actual expenses incurred. Even if the Cost Reimbursement Prohibition were to result in lower fees, which our clients uniformly believe is unlikely, that would not necessarily result in higher investor returns. In fact, the opposite may be true if, as a consequence of the prohibition, multi-strategy advisers are not able to pursue new strategies as flexibly and dynamically as they do today. Lower returns and limits on the advisers' ability to execute on their multi-strategy mandate would likely be the principal source of investor harm, but are not identified or considered in the Proposed Rules. Sources cited by the Proposed Rules themselves recognize that Actual Cost Advisers "have produced double-digit net returns over the long-term" and "have generally outperformed global indices with lower volatility."[32]

In addition to new fixed management fees, the Cost Reimbursement Prohibition could result in decreased investor transparency into regulatory and compliance costs, including the costs of complying with the SEC's regulatory framework, which investors will still ultimately bear. We and our clients are aware of no other industry in which managers of a business must absorb compliance expenses rather than having them borne (knowingly and voluntarily) by investors or shareholders or in which structures that promote transparency into such costs are discouraged. In light of the Proposed Rules' stated objective of providing transparency to investors, this is an odd result and perhaps unintended consequence of the Cost Reimbursement Prohibition that certainly seems contrary to the stated goals of, and proposals contained in, the Proposed Rules. The Proposed Rules suggest, without explanation, that the substitute management fee that would inevitably replace the actual cost reimbursements would be more transparent to investors.[33] But it is not at all clear how such a fee structure, which is by definition an estimate of expected costs rather than actual costs incurred, could possibly increase transparency.

Further, the Cost Reimbursement Prohibition may create significant barriers to entry for smaller and newly formed investment advisers, which may have less ability to increase

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[31] 87 Fed. Reg. at 16948–49.

[32] Id. at 16948, n.334 (internal citations omitted). There is evidence that Actual Cost Advisers may in fact tend to run better-performing investment strategies. Analysis by a Barclays Prime Services Capital Solutions team found that "[t]he comparison of returns and other performance metrics appears to show that multi-managers that include a partial or full pass through have outpaced both multi-managers that do not charge a pass through as well as those with traditional [hedge fund] fees across net returns, alpha, and Sharpe [ratio]." The Aurum Hedge Fund Data Engine reports that cumulative AUM-weighted performance from 2012 through the present was higher for hedge funds with pass-through expense models (190.6%) than for all hedge funds (73.3%). There can, of course, be debate about the significance of results data such as these—which is precisely what does not happen if such data are not considered in the rulemaking process.

[33] 87 Fed. Reg. at 16948.

their management or similar fees or to bear the additional costs that the prohibition would impose. These barriers to entry act to limit investor choices and potentially impede other efforts by the SEC to promote greater diversity within the asset management industry. The Proposed Rules, however, do not address these costs. The Proposed Rules also do not consider that, as a fund increases in size, an actual cost structure can be preferable to an estimated fixed cost structure as actual cost structures provide the benefit of scale while estimated fixed cost structures do not.

Also, because the market is not static, any fund restructurings (which would require revisions to the existing contracts advisers have with investors) that are undertaken would likely impose additional costs that may be borne partially or entirely by investors. For instance, any fund restructuring may require Actual Cost Advisers to offer investors a right of redemption in advance of altering investment terms to comply with the Cost Reimbursement Prohibition. Depending on the posture of the fund at the time the redemption right is offered, this could have a negative impact on the investors who choose not to redeem. Moreover, to the extent that restructuring an actual cost expense model of a private fund diverts the fund's resources away from its investment strategy, restructuring could lead to a lower return to investors in such funds. Even if advisers do not in any way set out to reduce resources dedicated to their investment strategies, resources are finite, and the required trade-offs may be subtle. Further, because the Proposed Rules have no grandfathering provision with respect to the Cost Reimbursement Prohibition, if Actual Cost Advisers are unable to restructure active funds and negotiate a new fixed management fee, such advisers will bear substantial costs at a meaningful disadvantage to advisers using a management fee structure today.

In addition to general regulatory and compliance fees and expenses, the Cost Reimbursement Prohibition would prohibit an adviser to a private fund from being reimbursed on an actual cost basis by the fund for fees and expenses associated with an examination or investigation of the adviser or its related persons by a governmental or regulatory authority. The Proposed Rules suggest, without offering any evidence for the assertion, that such reimbursement incentivizes advisers to engage in excessive risk-taking, as the advisers will not bear the cost of any ensuing government or regulatory examinations or investigations.[34] This claim is simply untrue in our and our clients' experience. First, the costs of government or regulatory examinations or investigations may well be budgeted for in the calculation of management fees, which reflect an estimation of an adviser's cost of doing business, of which government or regulatory examinations and investigations are a part, and so investors bear these costs regardless of the expense structure. Further, in an industry where reputation and client trust are paramount to survival and success, it is these considerations, along with expected gains for investors, that inform the level of risk appetite of the adviser—not whether the adviser can maneuver to avoid the cost of an examination or investigation.

Further, the fact that an examination or investigation has taken place does not suggest there has been wrongdoing by the adviser. Investment advisers are examined by the SEC in the ordinary course without suspicions of wrongdoing. Participating in and responding to such routine examinations are normal operating expenses of investment advisers. Even in

[34] See id.

cases where an examination or investigation results in a settlement, there has been no determination of guilt, and in many cases, the settling respondent is firmly of the view that no wrongful activity took place. The Cost Reimbursement Prohibition unfairly suggests a presumption of guilt and would do far more to distort settlement incentives than to improve them.

If the SEC's enforcement staff, or another government agency, believes in a particular case that the activity of the adviser so warrants, including in cases of fraud or deception, a much more targeted alternative exists—insistence on a condition to settlement that the adviser, rather than the fund, bear the expenses of settlement and any expenses incurred in contesting the charges (and in the rare litigated case, the SEC or other government agency can ask the court to issue a comparable order).[35] The SEC's enforcement staff will have visibility into the particular facts and circumstances in order to make such determination in the context of an examination or investigation.

The fact that a proposal has expected costs is not disqualifying if the proposal's expected benefits outweigh these costs. In this case, however, the Proposed Rules fail to articulate why it is a benefit to treat regulatory and compliance fees and expenses of an adviser, including those associated with an examination or investigation of the adviser, differently from any other expense of a fund management business. All advisers endeavoring to operate their businesses in a compliant manner will incur costs and expenses to do so in the ordinary course—it is not inappropriate, nor is it inherently fraudulent or deceptive, for the adviser to be reimbursed for those costs, which are universal in a highly regulated industry such as asset management, in a manner that aligns the adviser's incentives with those of its investors.

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The advisers on whose behalf this letter is written appreciate the opportunity to provide their comments, and we would welcome the opportunity to discuss them further with you. If you have any questions, please contact [redacted]

Respectfully submitted,

Sullivan & Cromwell LLP

[35] The SEC has, in fact, taken this approach in the past in cases involving a finding of misconduct by the adviser, including by adding as a condition to settlement that the adviser not take tax deductions on the amount of disgorgement or civil money penalties or offset amounts owed to investors under private actions by the civil penalties paid to the SEC. See, e.g., Fred Alger Mgmt., Inc. & Fred Alger & Co., Inc., Advisers Act Release No. 2580 (Jan. 18, 2007).