The SEC's Proposed Rule for Private Fund Reforms

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I. Executive Summary

1. The purpose of this report is to provide economic analysis to assist the United States Securities and Exchange Commission (the "SEC" or the "Commission") in its deliberations with respect to new rules proposed under the Investment Advisers Act of 1940 (the "Advisers Act" or the "Act") entitled "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews."[1]

2. Based on my review of the proposed rule, and my own experience and discussions with market participants, I have concluded that:

   a. The Commission has not sufficiently demonstrated that a market failure exists in the operation of the negotiating process between sophisticated, knowledgeable, and well-informed counterparties in the private funds industry.

   b. The Commission has not sufficiently demonstrated that a market failure exists in the private funds industry with regard to the pass-through of certain fees or the use of clauses seeking indemnification from liability (more succinctly referred to as "hedge clauses" throughout my report). Moreover, the Commission has not sufficiently demonstrated that the prohibition of certain activities as proposed in the Proposing Release is more efficient or conducive to capital formation than other interventions.

   c. The Commission has failed to consider that pass-through expense models may be an efficient outcome of negotiations between private funds and investors, and that eliminating this expense model will limit investor choice and alter the competitive dynamics of the private fund sector.

   d. The Commission has failed to consider whether the inclusion of hedge clauses in investment management contracts may be an optimal outcome of negotiations between well-informed and sophisticated parties, and that prohibiting such clauses will limit investor choice, leading to less efficient investor outcomes, and may lead to higher costs for investors.

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[1] "Proposed Rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews," Release No. IA-5955, *SEC*, February 9, 2022 ("Proposing Release").

II. Overview of the Proposed Rule and Asserted Benefits

3. In the proposed rule, the Commission proposes to prohibit all private fund advisers from "engaging in certain sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors."[2] Among other things, the proposed rule would prohibit an adviser from (i) "charging a private fund for fees or expenses associated with an examination or investigation of the adviser …by any governmental or regulatory authority, as well as regulatory and compliance fees and expenses of the adviser"[3] and (ii) "seeking 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."[4] The Commission claims that "these activities incentivize advisers to place their interests ahead of their clients' …and can result in private funds and their investors …bearing an unfair proportion of fees and expenses," particularly for "smaller investors that are not able to negotiate preferential deals with the adviser."[5]

4. Section 202(c) of the Advisers Act requires the Commission, when it engages in rulemaking, to consider, in addition to the protection of investors, whether a regulatory action will promote efficiency, competition, and capital formation.[6] In this report, I opine on the analysis of the likely economic impact of the proposed rule as contained in the Proposing Release, focusing on key questions the Commission may wish to consider in evaluating the proposed rule and alternative approaches to achieving their regulatory objectives.

5. I have formed my views based on the Commission's protocol for conducting economic analysis in rulemaking[7] and my own experience in assessing the economic impact of federal rules over the past 30 years, including my experience as the Commission's Chief Economist from 2007 to 2010. In my role as Chief Economist, I directed the Commission's process for assessing the likely economic impact of proposed rules and rule changes. I have

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[2] Proposing Release, p. 1.
[3] Proposing Release, p. 140.
[4] Proposing Release, p. 150.
[5] Proposing Release, p. 132.
[6] Proposing Release, p. 184.
[7] "Memorandum to Staff of the Rulewriting Divisions and Offices From RSFI and OGC Re: Current Guidance on Economic Analysis in SEC Rulemakings," March 16, 2012 ("Memorandum on Current Guidance on Economic Analysis in SEC Rulemakings").

also based my views on information I have gathered from discussions with industry practitioners.

6. The Commission asserts that even when certain fees and expenses (such as those related to investigations) are disclosed, they can still "incentivize advisers to engage in excessive risk-taking, as the adviser will no longer bear the cost of any ensuing government or regulatory examinations or investigations."[8] The Commission states that a prohibition on these fees would benefit investors in the form of "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."[9] The magnitude of the benefit would "depend on whether advisers could introduce substitute charges (for example, increased management fees) …for the purpose of making up any revenue that would be lost to the adviser from the prohibition."[10]

7. The Commission recognizes that certain private fund advisers utilize a "pass-through" expense model "where the private fund pays for most, if not all, of the adviser's expenses, and that in exchange, the adviser does not charge a management, advisory, or similar fee (but does charge an incentive or performance fee on net returns of the private fund)."[11] But the Commission maintains that "[s]ome investors may not anticipate the performance implications of these disclosed costs," which could "lead to a mismatch between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes, relative to what would occur in the absence of such unexpected or uncertain costs."[12]

8. Regarding the prohibition on hedge clauses,[13] the Commission argues that "the elimination of liability for adviser misconduct could reduce or eliminate investor recoveries of losses in connection with misconduct, which could make such misconduct more likely to occur."[14] By prohibiting these contractual clauses, the Commission states that "such breaches of fiduciary duty [would be] incrementally less likely to occur."[15]

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[8] Proposing Release, p. 235.
[9] Proposing Release, p. 234.
[10] Proposing Release, p. 235.
[11] Proposing Release, p. 192.
[12] Proposing Release, pp. 192–193.
[13] The Commission has previously defined a hedge clause as "a clause in an agreement, or a statement in disclosure documents provided to clients and investors, that purports to limit an adviser's liability." *See* "Observations from Examination of Private Fund Advisors," *SEC*, January 27, 2022, p. 5.
[14] Proposing Release, p. 193.
[15] Proposing Release, p. 244.

9. The Commission asserts that the private fund market is characterized by a "lack of transparency regarding costs, performance, and preferential terms," which it claims "causes an information imbalance between advisers and private fund investors."[16] The Commission asserts that the information imbalance "in many cases, prevents private bilateral negotiations from effectively remedying shortcomings in the private funds market."[17] The Commission also claims that certain conflicts of interest between private fund advisers and their investors "cannot be managed given the lack of governance mechanisms frequent in private funds."[18]

III. The Proposed Private Fund Rule Interferes With the Operation of a Competitive Market Involving Sophisticated and Knowledgeable Counterparties

A. The Commission Has Provided No Evidence of a Market Failure That Necessitates the Proposed Rule and Has Not Sufficiently Considered Reasonable Alternatives

10. As justification for the proposed private fund rule, the Commission characterizes the private funds market as broken and requiring intervention. The Proposing Release claims that "[w]ithout Commission action, private funds and private fund advisers would have limited abilities and incentives to implement effective reform" because "investors and advisers compete and negotiate independently of each other"[19] and "[a]dvisers may not have sufficient incentives and abilities to commit to a solution to [principal-agent] problems with existing governance mechanisms."[20] The Commission also claims that "[c]ertain practices, even if appropriately disclosed or permitted by private fund offering documents, represent potential conflicts of interest and sources of harm to funds and investors" and that "private funds typically lack fully independent governance mechanisms more common to other markets that would help protect investors from harm in the context of the activities considered."[21] However, the Commission relies upon only vigorous assertion to support this view and fails to provide data, tangible evidence, or rigorous analysis to provide a reasoned basis to justify its proposed intervention, including the prohibition of several activities.

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[16] Proposing Release, p. 11.
[17] Proposing Release, p. 11.
[18] Proposing Release, p. 15.
[19] Proposing Release, p. 213.
[20] Proposing Release, p. 214.
[21] Proposing Release, pp. 217–218.

11. As an initial matter, the Commission does not provide any data that could corroborate the existence of a market failure with respect to the proposed interventions. Indeed, the Commission acknowledges that:

> *"[T]here is a lack of data on the extent to which advisers engage in certain of the activities that would be prohibited under the proposed rules, as well as their significance to the businesses of such advisers. ...[T]here is a lack of data regarding how and to what extent the changed business practices of advisers would affect investors, and how advisers may change their behavior in response to these prohibitions. Further, there is a lack of data on the frequency with which advisers grant certain investors the preferential treatment that would be prohibited under the proposed rules, as well as the frequency with which preferential terms are currently disclosed to other investors, as well as how and to what extent these disclosures affect investor behavior."*[22]

Without any data on which to base a thorough economic analysis, the Proposing Release instead relies on unsupported staff "observations" throughout.

12. The Commission also attempts to motivate the need for the proposed rule by citing to examples of enforcement actions.[23] Yet these individual examples of actions taken against specific funds cannot support a claim of widespread market failure for several reasons. First, even if the cited examples are only a sample of similar actions pursued by the Commission, enforcement actions are still only brought against a small percentage of private fund managers, given that the Proposing Release identifies over 44,000 private funds that are managed by registered investment advisers.[24] If anything, these examples highlight the limits on the ability of a private fund adviser to engage in wrongdoing and the effectiveness of the *current* regulatory regime. They do not, by themselves, corroborate the existence of a market failure. Second, all but one of the 13 enforcement actions cited in the "Background and Need for Reform" section of the Proposing Release settled without any admission of wrongdoing by the company at-issue. Finally, the relevant conduct in at least two of these actions occurred prior to the Commission's adoption in 2011 of a rule requiring certain advisers to hedge funds and other private funds to report information on Form PF.[25] That rule mandated

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[22] Proposing Release, pp. 233–234.
[23] Proposing Release, pp. 7–16.
[24] Proposing Release, p. 189. For example, the Commission filed a total of 434 new enforcement actions in fiscal year 2021, which cover all types of conduct regulated by the Commission. *See* "Press Release: SEC Announces Enforcement Results for FY 2021," *SEC*, November 18, 2021.
[25] "Joint Final Rules: Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF," *Commodity Futures Trading Commission and SEC*, Release No. IA-3308, October 31, 2011.

a substantial increase in disclosure by private funds to the Commission. The Commission does not consider whether the disclosures mandated by the rule have since obviated the need for more restrictive rules regarding the same conduct.

13. In this Proposing Release, the Commission has also failed to properly characterize the competitive nature of the private funds industry, and the extent to which competition between fund advisers for investor funds provides a disciplining mechanism that aligns adviser incentives with those of investors. For example, a report published by the Commission found that the hedge fund industry grew both in terms of number of funds and value of assets between the third quarter of 2019 and the second quarter of 2021, and that the relative importance of the largest hedge funds declined over the same period.[26, 27] These facts demonstrate that investors have an increasing amount of hedge funds to choose from, and therefore that hedge funds compete with each other to attract funds from investors.

14. Empirical evidence suggests that this increased competition has helped discipline fees in the hedge fund sector, as industry reports have found management fees are declining.[28] One source found that average management fees for hedge funds were 1.4 percent in the fourth quarter of 2020, down from the 1.6 percent it had found a decade prior.[29] Another source documented, by means of a survey, that hedge funds compete with each other on fees and fee structures, and noted "two thirds of managers [had] adopted or [were] considering nontraditional fee structures in a bid to attract investors."[30] However, only seven percent of hedge fund managers offering nontraditional fee structures operated a pass-through expense

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[26] A Commission report presenting data from the third quarter of 2019 to the third quarter of 2021 shows an increase in the total number of private funds from 32,710 to 37,531 and the total number of hedge funds from 9,506 to 9,613. The net asset value ("NAV") also increased from $9,086 billion to $12,102 billion for all private funds and $4,066 billion to $5,132 billion for hedge funds. *See* "Private Fund Statistics," *SEC*, January 14, 2022, pp. 4–5.

[27] Between the third quarter of 2019 and the second quarter of 2021, the share of total NAV held by the ten largest hedge funds decreased from 7.4 percent to 7.0 percent. Similarly, the share held by the 25 largest hedge funds decreased from 13.6 percent to 13.0 percent. *See* "Private Fund Statistics," *SEC*, January 14, 2022, p. 22.

[28] *See, e.g.*, Nishant Kumar, Demetrios Pogkas, and Hema Parmar, "Hedge Fund Fees in Free Fall Is the New Reality for a Humbled Industry," *Bloomberg*, July, 27, 2020.

[29] Leslie Picker, "Two and Twenty Is Long Dead," *CNBC*, June 28, 2021, citing Hedge Fund Research.

[30] "2017 Global Hedge Fund and Investor Survey," *EY*, 2017, p. 13. A similar survey in 2020 found that 51 percent of North American hedge fund managers had adopted "nontraditional alternative fee structures." *See* "2020 Global Alternative Fund Survey," *EY*, 2020, p. 21.

model in 2020.[31] Thus, the pass-through expense model is just one of the many fee structures available for the sophisticated private investors to choose.[32]

15. Besides failing to document a market failure using concrete data and a thorough economic analysis, the Commission has also neglected to gather concrete data for an examination of the costs and benefits of reasonable alternatives to the proposed rule. Specifically with respect to disclosures, which, as discussed below, could address the Commission's concerns with respect to both pass-through expense models and hedge clauses, the Proposing Release simply asserts, without concrete data, that "[c]ertain practices, even if appropriately disclosed …, represent potential conflicts of interest and sources of harm to funds and investors," and that since these "conflicts of interest and sources of harm may be difficult for investors to detect or negotiate terms over, full disclosure of the activities considered in the proposal would not likely resolve the potential investor harm."[33]

16. Therefore, given the lack of data and concrete analysis included in the Proposing Release, the Commission has not sufficiently demonstrated that a market failure exists in the private funds industry, or that the proposed rule would be the preferred form of intervention, should one be needed.

B. A Pass-Through Model for Regulatory and Compliance Inspections May Be an Optimal Outcome of Negotiations between Informed Parties

17. As discussed above, two elements of the proposed rule would prohibit advisers from charging a private fund for "(i) fees and expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, and (ii) regulatory or compliance fees and expenses of the adviser or its related persons."[34] The Commission asserts that "allocating these types of expenses to a private fund

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[31] "2020 Global Alternative Fund Survey," *EY*, 2020, p. 22. Examples of other nontraditional fee structures considered were "Performance fee only charged above a hurdle" and "1% or 30%."

[32] Consistent with the 2017 EY survey, a 2020 survey found that only seven percent of hedge fund managers offering "nontraditional alternative fee structures" had adopted a "[c]ost pass-through model in lieu of management fees." *See* "2020 Global Alternative Fund Survey," *EY*, 2020, p. 22.

[33] Proposing Release, pp. 217–218. *See also* Proposing Release, p. 276 ("We could also consider requiring detailed and standardized disclosures of the activities under consideration, instead of prohibiting the activities outright. This alternative may be desirable to the extent that certain investors would be willing to bear the costs of these activities in exchange for certain other beneficial terms, and would be willing to give informed consent to fund advisers engaging in the practices under consideration. However, we do not believe that disclosure requirements would achieve the same benefit of protecting investors from harm, because many of the practices are deceptive and result in obscured payments, and so may be used to defraud investors even if detailed disclosures are made.").

[34] Proposing Release, p. 140.

client is contrary to the public interest and is harmful to investors because they create an incentive for an adviser to place its own interests ahead of the private fund's interests and unfairly allocate expenses to the fund, even where fully disclosed."[35]

18. However, the Commission has not completed the necessary work to support the assertion that these expenses are harmful to investors, nor has it demonstrated that intervention by the Commission is necessary to address a market failure. Relatedly, the Proposing Release fails to clearly identify the justification for the proposed rule, which the Commission's own guidance requires as part of its evaluation of the economic consequences of a proposed rule.[36]

19. Further, the Commission's economic analysis fails to properly consider all potential costs of this prohibition. The Proposing Release acknowledges that prohibiting the pass-through of regulatory, compliance, and examination-related expenses "would likely require advisers that pass on [these] fees and expenses …to re-structure their fee and expense model."[37] By effectively requiring a re-structuring of pass-through expense models for regulatory, compliance, and examination-related expenses, the proposed rule may reduce investor choice, limit certain types of competition among hedge funds, raise costs for certain investors, and impair the ability of investors to efficiently construct investment portfolios that meet their investment objectives.

1. The Commission Has Not Demonstrated a Market Failure with Respect to the Pass-Through of Regulatory, Compliance, and Examination-Related Expenses

20. The Commission has not provided sufficient evidence to demonstrate that a market failure exists with respect to the types of fees it proposes to prohibit. In the Proposing Release, the Commission claims that charging the fund for expenses associated with investigations or compliance is "contrary to the public interest."[38] This claim is supported only by the Commission's observation that there has been "an increase in private fund advisers charging these expenses"[39] and the hypothetical assertion that "[s]ome investors may not anticipate the performance implications of these disclosed costs, or may avoid

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[35] Proposing Release, p. 141.
[36] Memorandum on Current Guidance on Economic Analysis in SEC Rulemakings, p. 5.
[37] Proposing Release, p. 141, footnote 157.
[38] Proposing Release, p. 141.
[39] Proposing Release, p. 140.

investments out of concern that such costs may be present."[40] Additionally, while the Commission cited a set of enforcement actions as motivation for the Proposing Release, none of these actions pertained specifically to funds passing through regulatory, compliance, or examination-related expenses.[41] The Commission thus lacks empirical evidence to support its argument that certain private funds are able to pass through regulatory, compliance, and examination-related expenses as the result of some market failure, as opposed to the result of the free, fully-informed choices of sophisticated investors.

21. In fact, the Proposing Release indicates that the Commission has neither gathered sufficient data nor conducted sufficient analyses to demonstrate that a market failure with respect to pass-through of regulatory, compliance, and examination-related expenses exists. First, the Commission has not addressed the fundamental questions of whether pass-through expense models are widespread or have harmed a large number of investors, as would presumably be the case if there were an underlying market failure. If anything, the Proposing Release appears to support the case that the pass-through of these expenses is *not* a pervasive issue, as the Commission states it does "not anticipate this aspect of the proposed prohibited activities rule [to] cause a dramatic change in practice for most private fund advisers."[42] As further evidence of this point, a survey from 2020 found that only seven percent of hedge fund managers offering nontraditional fee structures operated a pass-through expense model at that time.[43] This suggests that investors have many alternative expense models to choose from, and highlights the Commission's failure to demonstrate how a practice representing a small portion of the market, but chosen by some sophisticated investors, could represent a market failure.

22. Second, the Commission has not quantified the expected benefits of correcting the supposed market failure with respect to pass-through of regulatory, compliance, and examination-related expenses, nor has it estimated the potential costs to the industry. The Commission notes that "there is a lack of data on the extent to which advisers engage in certain of the activities that would be prohibited under the proposed rules, as well as their

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[40] Proposing Release, p. 192.

[41] *See* Proposing Release, Section I. I note this lack of relevant enforcement actions, in addition to my prior discussion of the flaws in the Commission's use of enforcement actions as evidence of market failure, discussed in Section III.A.

[42] Proposing Release, p. 141.

[43] The same survey found that 51 percent of North American hedge fund managers had already adopted nontraditional fee models. *See* "2020 Global Alternative Fund Survey," *EY*, 2020, pp. 21–22.

significance to the businesses of such advisers"[44] and concludes that it would therefore be difficult to evaluate the costs and benefits of this aspect of the proposed rule. The justification for this rule therefore relies primarily on the Commission's observations about the market, rather than an analysis that public commenters can evaluate and provide feedback on. By failing to gather compelling data and analyses, the Commission fails to document a reasoned basis for the Commission's exercise of its rule-making authority with respect to pass-through of regulatory, compliance, and examination-related expenses.

23. Moreover, the Commission has failed to recognize that pass-through expense models may be an optimal (i.e., efficient) outcome of negotiations between private funds and investors. It simply asserts that the ability of private funds to charge certain fees is "contrary to the public interest and the protection of investors,"[45] and similarly that certain fees "create an incentive for an adviser to place its own interests ahead of the private fund's interests."[46] As discussed in more detail below, I do not agree that the pass-through of certain fees and expenses (e.g., those related to regulatory investigations and examinations) necessarily results in this inversion of incentives. Furthermore, academic literature on agency costs has demonstrated that it is possible for an optimal bargaining outcome to contractually eliminate some misalignment risks, but not others, depending on what is optimal for the parties involved. For example, according to Jensen and Smith (1985), "[i]ncentives exist to write contracts that provide monitoring and bonding activities to the point where their marginal cost equals the marginal gains from reducing the residual loss."[47]

24. Therefore, investors should be able to choose what level of alignment of interests is optimal. Specifically with regard to sophisticated investors, the Commission has previously adopted the view that accredited investors "have the resources and financial sophistication to assess private investment opportunities."[48] Thus, according to the Commission's own view, these investors should be able to determine what fees align with their interests, and whether any remaining residual risk that exists in the relationship may be mitigated through other

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[44] Proposing Release, p. 234.
[45] Proposing Release, p. 134.
[46] Proposing Release, p. 141.
[47] Michael C. Jensen and Clifford W. Smith Jr., "Stockholder, Manager, and Creditor Interests: Applications of Agency Theory," *Recent Advances in Corporate Finance,* 1985, pp. 93–131 at p. 96.
[48] "Proposed Rule: Amending the 'Accredited Investor' Definition," Release Nos. 33-10734 and 34-87784, *SEC*, December 18, 2019 ("Proposing Release on Accredited Investor Definition"), p. 103. Similarly, the Commission has defined "qualified institutional buyers," a term which would apply to certain investors in private funds, as entities which "have the financial sophistication and access to resources such that they do not need the protections of registration under the Securities Act." *See* Proposing Release on Accredited Investor Definition, p. 92.

means such as disclosures and monitoring. Interfering in the formation of contracts between sophisticated counterparties will likely impair the efficiency of the outcomes from the contracting process.

25. Finally, I note the Commission's unfounded claim that the pass-through of certain specific regulatory and compliance expenses weakens private fund advisers' incentives to minimize those expenses. The Commission's claim appears to be based on a false premise that compliance and regulatory examinations and investigations are perfectly correlated with actual wrongdoing by the adviser. Instead, compliance and regulatory investigations are not by themselves indications of wrongdoing. For example, examinations of an adviser by the Commission's Division of Examinations do not assume any wrongdoing by the adviser. Investors may be willing to bear the cost of regulatory and compliance-related expenses in order to encourage fund managers to pursue novel and complex strategies that may yield higher returns, as well as to appropriately incentivize advisers to invest in compliance. Investment in compliance prior to or during an investigation may help to exculpate an adviser whose conduct has mistakenly been called into question, whereas under-investment would increase the risk of fines or restrictions on conduct, which could reduce the incentive to innovate.

2. Pass-Through Expense Models Provide an Alternative to the Traditional Hedge Fund Fee Model

26. Private funds (particularly hedge funds) operate under several different business models and fee models, providing investors with valuable alternatives in order to efficiently achieve their investment objectives. The traditional approach to hedge fund fees has been to charge a fixed management fee based on total assets, as well as a performance-based fee based on realized gains, which was popularized as the 2-and-20 fee structure.[49] However, this fixed fee model has been challenged by many investors over time, leading some fund advisers to adopt alternative expense models to compete to attract investors.[50] Pass-through expense models provide such an alternative to investors, in which "[a]ll costs — such as

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[49] Leslie Picker, "Two and Twenty Is Long Dead," *CNBC*, June 28, 2021.

[50] "2020 Global Alternative Fund Survey," *EY*, 2020, p. 21 ("As investor dissatisfaction around traditional fee structures is showing no signs of abating, managers partly have responded by continuing to offer nontraditional alternatives."); "2017 Global Hedge Fund and Investor Survey," *EY*, 2017, p. 13 ("Two thirds of managers [had] adopted or [were] considering nontraditional fee structures in a bid to attract investors.").

salaries, bonuses and technology development — are reimbursed by investors in lieu of a management fee."[51]

27. While advisers charge performance fees in both models (i.e., the traditional fixed fee model and the pass-through expense model), the advisers' approaches to funding their operating costs differ between the two models, with associated tradeoffs from the perspective of investors. A fixed fee model presents investors with a known management fee based on an estimate of the adviser's future expenses. But this fee may be greater or lesser than the actual expenses incurred by the fund adviser, as these expenses are often variable year-over-year. Moreover, while the fixed fee model removes uncertainty about the amount the investor will pay, it decreases the adviser's incentives to invest in the operation, infrastructure, and personnel of the fund above the amount that can be covered by the fixed fee. In contrast, the pass-through model allocates the actual operating costs of the adviser and its funds to the investor, allowing for expense variability year-over-year. While the cost to the investor may be higher than a fixed fee,[52] the investor shares in the rewards of the additional investment in technology, infrastructure, and talent that may be able to generate greater returns for the fund.[53]

28. Importantly, investors in hedge funds are currently able to choose from a menu of options provided in a competitive marketplace for the models they prefer to use for investing their money.[54] While some investors may prefer the fixed fee model, others may prefer the variable approach provided by pass-through expense models.[55] When making investment decisions, the latter group of investors may prefer to focus on the net return hedge funds provide (as certain funds which utilize pass-through models have historically performed well for clients).[56] One possible way for the Commission to evaluate whether investors in funds using pass-through models prefer this arrangement would be to consider reinvestment rates.

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[51] Robin Wigglesworth, Laurence Fletcher, and Ortenca Aliaj, "How Ken Griffin Rebuilt Citadel's Ramparts," *Financial Times*, April 6, 2021.

[52] According to an article cited in the Proposing Release, Citadel charged fees of up to 5.3 percent in 2015 and 6.3 percent in 2014. *See* Eli Hoffmann, "Welcome to Hedge Funds' Stunning Pass-Through Fees," *Seeking Alpha*, January 24, 2017.

[53] According to that same article cited in the Proposing Release, Citadel's annual performance since 1990 is a "whopping 19.5%." *See* Eli Hoffmann, "Welcome to Hedge Funds' Stunning Pass-Through Fees," *Seeking Alpha*, January 24, 2017.

[54] *See* "2020 Global Alternative Fund Survey," *EY*, 2020, pp. 21–22.

[55] For example, one survey found that in 2018, 0 percent of insurance companies invested in funds with pass-through fees, while 14 percent of family offices did. *See* "2019 Institutional Investor Survey," *J.P. Morgan*, 2019, p. 15.

[56] *See* Eli Hoffmann, "Welcome to Hedge Funds' Stunning Pass-Through Fees," *Seeking Alpha*, January 24, 2017.

If investors in these funds continue to invest with the same advisers, that would provide evidence against the Commission's claim that these investors are harmed and that charging these fees is "contrary to the public interest."[57] However, as mentioned above, the Commission did not attempt to support its assertions with any such analysis or data.

3. Pass-Through Expense Models Promote Competition between Hedge Funds

29. The Proposing Release acknowledges, but does not sufficiently address, the impact that prohibiting the pass-through of regulatory, compliance, and examination-related expenses may have on funds operating a pass-through expense model. The Commission acknowledges that the proposed rule "would likely require advisers that pass on [these] fees and expenses …to re-structure their fee and expense model"[58] and mentions that "an exemption for funds utilizing a pass-through expense model …would allow advisers to avoid the costs associated with re-structuring any arrangements not compliant with the prohibition, given the proposed rules would likely prohibit certain aspects of these expense models."[59] However, the Commission has not adequately considered the potential indirect costs associated with such restructurings, including costs resulting from a reduction in competition between funds.

30. Hedge funds compete with each other for investors. One dimension of this competition is through the choice of business model.[60] Given a menu of competing business models in the marketplace, investors can select the business model that is appropriate for them and efficiently achieve their investment objectives. As discussed above, the Commission's proposed prohibition of certain fees and expenses will effectively eliminate the choice for private fund advisers to utilize a full pass-through model, and will therefore limit investor choice.[61] By removing the ability for advisers to choose how they charge their

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[57] Proposing Release, p. 141.
[58] Proposing Release, p. 141, footnote 157.
[59] Proposing Release, p. 276.
[60] A 2017 survey documented that hedge funds compete with each other on fees and fee structures, and noted that "[t]wo thirds of managers [had] adopted or [were] considering nontraditional fee structures in a bid to attract investors." *See* "2017 Global Hedge Fund and Investor Survey," *EY*, 2017, p. 13.
[61] *See* Proposing Release, p. 141, footnote 157 ("We recognize that this aspect of the proposed rule would likely require advisers that pass on the types of fees and expenses we propose to prohibit to re-structure their fee and expense model."). *See also* Proposing Release, p. 236 ("The proposed rules would likely prohibit certain aspects of pass-through expense models or other similar models in which advisers charge investors fees associated with certain of the adviser's cost of being an investment adviser. These expenses that would no

clients, the Commission will limit competition and investor choice rather than promote it.[62] The end result will likely be that investors will have an impaired ability to manage their investment portfolios and efficiently meet their investment objectives.

31. Private fund fee models also affect how funds can operate, how they fund their businesses, and what resources they will have to compete with each other. While the Proposing Release focuses much of its discussion on the type and amount of costs that are charged to investors by private funds, it largely ignores the potential benefits that greater investment in a fund (by allocating certain expenses to investors) can have on its ability to generate greater returns for those investors. Two important ways in which firms invest in their businesses are through talent and technology, and both of these markets are highly competitive.[63]

32. First, the search for talent among hedge funds is highly competitive in a "world where …talent is both scarce and choosy."[64] Pass-through models allow firms to provide greater compensation to attract and retain talented employees. Second, hedge funds are increasingly investing in new technology, as some market observers predict that the industry will "double down" on technology, specifically alternative data.[65] A recent survey found that 48 percent of hedge funds with more than $1 billion in assets under management are investing in technology.[66] This trend seems likely to continue as investment advisers look to take advantage of the opportunity to incorporate increasing information into investment decisions.[67] Pass-through models similarly allow firms to invest more in the capabilities to pursue these alternative data-driven strategies. These types of investments are what separate

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longer be passed through to the fund could represent additional costs to the fund adviser, unless the adviser negotiates a new fixed management fee to compensate for the new costs.").

[62] The Commission appears to acknowledge that funds that pass-through costs would need to change their business model, as the Proposing Release states that "[t]he proposed rules would likely prohibit certain aspects of pass-through expense models or other similar models in which advisers charge investors fees associated with certain of the adviser's cost of being an investment adviser. These expenses that would no longer be passed through to the fund could represent additional costs to the fund adviser, unless the adviser negotiates a new fixed management fee to compensate for the new costs." *See* Proposing Release, p. 236.

[63] Sarah Butcher, "The Hedge Funds that Can Hire Whomever They Want," *eFinancial Careers*, December 18, 2019.

[64] Sarah Butcher, "The Hedge Funds that Can Hire Whomever They Want," *eFinancial Careers*, December 18, 2019.

[65] Jessica Hamlin, "Amid the Pandemic, Hedge Funds Grapple with Investments in New Tech and Alternative Data," *Institutional Investor*, April 6, 2021.

[66] Jessica Hamlin, "Amid the Pandemic, Hedge Funds Grapple with Investments in New Tech and Alternative Data," *Institutional Investor*, April 6, 2021.

[67] Christine Idzelis, "It's Time to 'Cash In' on Big Data," *Institutional Investor*, October 26, 2020.

hedge funds from passively-managed, low-fee alternatives, which are available to investors (with a corresponding level of expected return).

33. The Commission acknowledges the potential impact on returns that prohibitions of certain pass-through expenses might have. The Proposing Release states that "investors may incur costs …that take the form of lower returns …depending on the extent to which the prohibition limits the adviser's efficiency or effectiveness in providing the services that generate returns from [some fund] investments. For example, …fund advisers who would have to bear new costs of providing certain services under the prohibition may reduce or eliminate those services from the fund."[68] However, the Commission does not discuss these specific issues in any detail, nor does it attempt to estimate the cost associated with limiting these expenses and potentially lowering competition and the ability to pursue novel strategies to generate returns as a result.

4. The Prohibition of Passing Through Investigation Fees Will Impose Costs on Funds That Utilize A Pass-Through Expense Model and Their Investors

34. The proposed rule will impose directs costs on advisers and investors of funds that utilize a pass-through expense model. Among these costs, which the Commission does not sufficiently address or quantify in the Proposing Release, are the costs to both advisers and investors of reorganizing the structures of funds that currently utilize pass-through models and the subsequent costs to investors of searching for alternative funds that are able to generate similar returns using similar strategies. While the Commission asserts that these costs would be transitory,[69] they could adversely affect competition and investor choice, and should therefore be properly quantified in the Proposing Release. In addition, were such advisers to adopt a management fee (or increase an existing management fee), such expenses would not likely be "transitory" as the management fee would be charged on an ongoing basis.

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[68] Proposing Release, pp. 236–237. *See also* Proposing Release, p. 237 ("Moreover, to the extent that re-structuring a pass-through expense model of a hedge fund under the proposal diverts the hedge fund's resources away from the hedge fund's investment strategy, this could lead to a lower return to investors in hedge funds.").

[69] Proposing Release, p. 236 ("In addition, any such fund restructurings that are undertaken would likely impose costs that would be borne by advisers. The costs may also be borne partially or entirely by the private funds, to the extent permissible or to the extent advisers are able to compensate for their costs with substitute charges (for example, increased management fees). These costs would likely be transitory.").

35. In the Proposing Release, the Commission acknowledges that the prohibition would "impose direct costs on advisers,"[70] but fails to quantify these. The Commission states that the proposed rule would "likely prohibit certain aspects of pass-through expense models or other similar models."[71] Therefore, funds would "need to update their charging and contracting practices to bring them into compliance with the new requirements"[72] and "may identify and implement methods of replacing the lost charges from the prohibited practice with the other sources of fund revenue." [73]

36. Besides the direct reorganization costs imposed on advisers to revise their business models, the proposed prohibition of the pass-through of regulatory, compliance, and examination-related fees also imposes costs on fund investors, as they would be forced to renegotiate their investment management contracts with fund advisers and re-examine their investment decisions. As an initial matter, the renegotiation process may be expensive and time consuming for both advisers and investors. Contracts between sophisticated parties are negotiated on all terms as a whole. Therefore, the process is unlikely to be as simple as replacing one term, since altering one term may require renegotiating all terms.

37. As a result of these renegotiations, either investors remain invested in the fund, or they leave and need to search for alternative investment opportunities. In the first case where investors remain with the fund, the Commission acknowledges that the adviser may negotiate "a new fixed management fee to compensate for the new costs."[74] This new fixed fee may result in these investors paying higher management fees overall. Advisers would likely attempt to set the new fees above the expected costs the fees are intended to cover, as they would want to account for potential cost variability.

38. In the second case where investors decide to re-allocate their funds, they would need to search for an alternative investment and switch. Investors will incur a direct cost associated with switching, but potentially also other costs in the form of lower returns or diminished service levels if they are not able to find a replacement that generates similar returns using similar strategies. While the Proposing Release references search-related costs when it states that "the cost to investors may include a combination of the cost of lower

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[70] Proposing Release, p. 235.
[71] Proposing Release, p. 236.
[72] Proposing Release, p. 235.
[73] Proposing Release, p. 236.
[74] Proposing Release, p. 236.

returns and the cost of avoiding such reductions in returns,"[75] the Commission does not attempt to make any direct comparison of these direct costs imposed on a particular set of investors to the supposed benefits of the prohibition.

C. Hedge Clauses May Be an Optimal Outcome of Negotiations between Sophisticated and Informed Parties

39. The Proposing Release seeks to "prohibit an adviser to a private fund, directly or indirectly, from seeking 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."[76]

40. As a basis for the proposed prohibition of hedge clauses, the Commission relies on "[its] staff['s] …observ[ation] [of] private fund agreements with waiver and indemnification provisions that have become more aggressive over time."[77] The Commission further posits that "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."[78]

41. However, based on my review of the Proposing Release, the Commission has not demonstrated a market failure with respect to hedge clauses. Moreover, the Commission has not examined how the prohibition of hedge clauses will likely limit investor choice, increase insurance costs and result in higher management fees to investors. These economic impacts speak directly to the degree investors are able to efficiently manage their investment portfolios in order to meet their investment objectives. Evaluating the impact of the proposed rule on efficiency is one of the required components of the Commission's consideration in determining whether a reasoned basis exists for the Commission to exercise its rulemaking authority.[79]

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[75] Proposing Release, p. 237.
[76] Proposing Release, p. 150.
[77] Proposing Release, p. 150.
[78] Proposing Release, p. 151.
[79] Proposing Release, p. 184.

1. The Commission Has Not Demonstrated a Market Failure with Respect to Indemnification of Advisers with Hedge Clauses in Investment Management Contracts

42. The "observation" by the Commission's staff that private fund agreements with hedge clauses have become more aggressive over time should not reasonably be considered evidence of a market failure for at least three reasons. First, the Commission does not support its staff's "observation" with concrete recent examples of situations in which investors were harmed by the presence of "more aggressive" hedge clauses.[80] In fact, as recently as 2019, the Commission itself held the view that hedge clauses between a private fund and an institutional client were not necessarily problematic. The Commission opined in 2019 that hedge clauses would need to be examined based on "particular facts and circumstances" before one could conclude whether they constituted a violation of the Advisers Act's antifraud provisions.[81] The Proposing Release lacks details as to *why* the Commission believes hedge clauses have become "more aggressive" over time since 2019, and why this alleged evolution constitutes a market failure.

43. Second, the Commission has acknowledged that it has not examined any data on the prevalence of hedge clauses (which is why it is requesting information from market participants as part of the Proposing Release).[82] Absent data on the prevalence of hedge clauses, the Commission cannot even begin to examine whether or not hedge clauses are indicative of a market failure. Typically, this requires characterizing both the prevalence of hedge clauses and the fraction of contracts with hedge clauses that have resulted in harm for one of the contracting parties.

44. Third, despite an existing literature on liability contracting, the Commission has failed to consider whether the inclusion of hedge clauses in investment management contracts may be an optimal outcome of negotiations between well-informed and sophisticated parties. While this literature focuses largely on product liability waivers and the incentives product manufacturers have to invest in product and consumer "care," the contracting problem between a fund and an investor is similar to that between a product manufacturer and a

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[80] The Proposing Release cites various enforcement actions in support of its proposal, but none of them are related to hedge clauses. *See* Proposing Release, pp. 7–16.

[81] "Interpretation: Commission Interpretation Regarding Standard of Conduct for Investment Advisers," Release No. IA-5248, *SEC*, June 5, 2019, p. 11, footnote 31.

[82] Proposing Release, pp. 233–234.

consumer. The Commission should therefore consider the implications of this literature for the Proposing Release and evaluate the impact on the ability of investors to efficiently enter into contracts that are consistent with their investment objectives.

45. Shavell (2009) examines liability contracting between firms and their customers.[83] He documents that when customers' knowledge is "perfect," competition between firms will lead them to take "optimal care [of their products/consumers] even in the absence of liability." The author explains:

> *To see exactly why, observe that in the absence of liability customers will bear their losses, and the full price will equal the market price plus expected accident losses. (The full price of a water heater will be seen as its price in the market plus the expected losses due to the possibility that it will rupture.) If a firm were to take less than optimal care, its potential customers would recognize this and factor into the full price the relatively high expected accident losses. Consequently, the firm's customers would go elsewhere; they would prefer to make their purchases from competitor firms exercising optimal care and offering the product at a lower full price, although at a higher market price. In other words, the force of competition will lead firms to take optimal care despite the absence of liability.*[84]

46. Thus, the Proposing Release should thoroughly examine the extent to which investors are sophisticated and able to assess the riskiness of the activities of private funds. If they are sophisticated, then the implication of the product liability literature is that contractual liability waivers between an investor and a fund may well be optimal and that prohibiting these waivers may impair the efficiency of the competitive contracting process. Notably, in the context of revising the "accredited investor" definition in 2020, the Commission upheld the view that accredited investors "have the resources and financial sophistication to assess private investment opportunities, despite the fact that these investments may have unique risk profiles and limited disclosure requirements."[85] If today the Commission still holds this view, then it should not prohibit private funds from including liability waivers in their contracts, as these may be optimal. If instead the Commission no longer holds the view that accredited investors are sophisticated and have the resources to assess the risk profiles of private funds, then the Commission should consider how fund disclosures can be improved, and whether

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[83] Steven Shavell, *Foundations of Economic Analysis of Law*, 2009, Harvard University Press, ("Shavell (2009)").
[84] Shavell (2009), p. 213.
[85] Proposing Release on Accredited Investor Definition, p. 103.

enhanced disclosures would be an efficient and cost-effective alternative to the proposed prohibition of hedge clauses and liability waivers.

2. The Commission Has Not Examined How the Prohibition of Hedge Clauses Will Limit Investor Choice

47. The Proposing Release fails to consider how the prohibition of hedge clauses will limit investor choice. When hedge clauses are prohibited, private funds will no longer be able to differentiate themselves from each other on this contractual feature. This effectively eliminates a mechanism of competition between funds, and reduces investor choice between contract types. By removing the choice for investors to enter into contracts with hedge clauses, the Commission is denying them of the potential benefits. For example, investors may be willing to indemnify an adviser in order to encourage them to pursue novel and complex strategies that may yield higher returns. The risk-return tradeoff is an economic principle that links an increase in risk with an increase in expected return. Thus, to increase expected returns, private fund advisers, like all other investors, must take certain calculated risks.[86] However, as investment risk increases, so too does the potential for litigation. Therefore, there is a clear tradeoff for the private fund adviser with regard to risk: calculated risks provide the potential benefits of higher returns, but also the potential downsides of losses and litigation risk. Hedge clauses are a mechanism that can be used by an investor to alter these tradeoffs for the adviser and incentivize an appropriate level of risk taking, if that is the desired strategy for the investor. Without a hedge clause, the adviser might be hesitant to pursue certain strategies to avoid potential litigation and the associated costs.

48. An additional implication of the proposed prohibition of hedge clauses is that funds may limit access to certain investors that are judged to represent a higher litigation risk to the fund. This may further reduce investor choice and impair the ability of investors to efficiently construct their investment portfolios in ways that meet their investment objectives.

49. In contrast to the Commission's commentary on the revision of the "accredited investor" definition in 2020, the Proposing Release fails to consider how reducing investor

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[86] The Capital Asset Pricing Model, for example, delivers an explicit formula for the trade-off between risk and expected return. *See*, *e.g.*, Stephen Ross, Randolph W. Westerfield, and Jeffrey F. Jaffe, *Corporate Finance*, 6th Edition, McGraw-Hill, p. 272 ("[T]he expected return on the market is the sum of the risk-free rate plus some compensation for the risk inherent in the market portfolio.").

choice, in turn, affects diversification and can harm the risk-return tradeoff of investors' portfolios.[87] The Commission itself wrote the following in 2020:

> *All else equal, expanding the set of investment opportunities can increase diversification and improve the risk-return tradeoff of an investor's portfolio. More specifically, adding private investments to the set of investable assets could allow an investor to expand the efficient risk-return frontier and construct an optimal portfolio with risk-return properties that are better than, or similar to, the risk-return properties of a portfolio that is constrained from investing in certain asset classes, leading to a more efficient portfolio allocation. For example, recent research has shown that investments in funds of private equity funds can outperform public markets. Thus, to the extent access to private offerings expands the efficient risk-return frontier for newly eligible accredited investors and qualified institutional buyers, we expect these investors will potentially benefit from an improvement in portfolio efficiency.*[88]

50. Thus, the Proposing Release appears wholly inconsistent with the Commission's position in the amendments to the "accredited investor" definition.

3. The Prohibition of Hedge Clauses Will Likely Increase Insurance Costs for Private Funds, which They May Pass on to Investors by Raising Management Fees

51. The Proposing Release fails to adequately consider how the prohibition of hedge clauses will impact fund costs. When permitted, hedge clauses lower funds' operating costs because they allow funds to avoid having to buy costly insurance to mitigate the risk of incurring litigation expenses. When prohibited, the threshold for liability is lowered and private funds will likely incur higher insurance costs to mitigate the increased risk of incurring litigation costs. These higher insurance costs would likely result in higher fund management fees, with the burden of these added costs ultimately borne by fund investors. The Commission acknowledges this possibility when stating that the benefits of the prohibition "may be diminished to the extent that advisers are able to obtain alternative permissible sources of compensation for these expenses from investors (for example, from increased management fees)."[89]

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[87] "Final Rule: Accredited Investor Definition," Release Nos. 33-10824 and 34-89669, *SEC*, August 26, 2020, p. 120.
[88] Proposing Release on Accredited Investor Definition, p. 120.
[89] Proposing Release, p. 244.

IV. The Commission Fails to Jointly Consider the Possible Impact of Other Proposed Rules with Potentially Similar Indirect Costs

52. While the Proposing Release includes a discussion of potential indirect costs associated with the proposed private fund rule, the Commission fails to comprehensively consider the potential unintended effects that may occur from the interaction costs resulting from the full slate of rules, including the ones discussed herein, being issued simultaneously (i.e., "knock-on effects"). In simultaneous rulemakings, the Commission is proposing several rules that will directly impact either private funds or the markets in which these funds operate.[90] The Commission cannot consider these rules in isolation because of the potential costs of regulatory accumulation, the many forms of which Mandel and Carew define.[91]

53. One type of regulatory accumulation is the interaction between regulations, in which "[m]ultiple regulations can interact in obvious or non-obvious ways that raise costs for businesses."[92] For example, the Proposing Release acknowledges that "to the extent that re-structuring a pass-through expense model of a hedge fund under the proposal diverts the hedge fund's resources away from the hedge fund's investment strategy, [the prohibition on the pass-through of certain expenses] could lead to a lower return to investors in hedge funds."[93] Yet the Commission does not consider the potential impact on hedge fund returns in the context of other proposed rules that may also impact hedge fund returns, such as the Proposing Release on Short Position and Short Activity Reporting. In that proposing release, the Commission recognized that by mandating increased disclosure of short position data, "other traders could use copycat trading strategies [to] try to mimic the Managers' strategy, potentially competing away the profitability of the strategy."[94] Therefore, a hedge fund that

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[90] *See, e.g.,* "Proposed Rule: Short Position and Short Activity Reporting by Institutional Investment Managers," Release No. 34-94313, *SEC*, February 25, 2022 ("Proposing Release on Short Position and Short Activity Reporting"); "Proposed Rule: Reporting of Securities Loans," Release No. 34-93613, *SEC*, November 18, 2021; "Proposed Rules: Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions," *SEC*, Release No. 34-93784, December 15, 2021; "Proposed Rule: Modernization of Beneficial Ownership Reporting," Release Nos. 33-11030 and 34-94211, *SEC*, February 10, 2022; "Proposed Rule: Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers," Release No. IA-5950, *SEC*, January 26, 2022.

[91] Michael Mandel and Diana G. Carew, "Regulatory Improvement Commission: A Politically-Viable Approach to U.S. Regulatory Reform," *Progressive Policy Institute*, May 2013 ("Mandel and Carew (2013)"), pp. 1–3.

[92] Mandel and Carew (2013), p. 3.

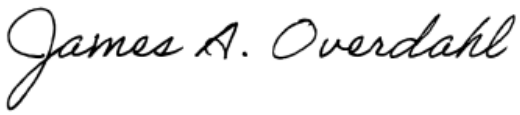
[93] Proposing Release, p. 237.

[94] Proposing Release on Short Position and Short Activity Reporting, p. 125.

engages in short selling may have its returns reduced by multiple proposed rules, which the Commission has not considered nor quantified in either of the individual proposing releases.

54. Further, by only considering these rules in isolation, the Commission is not providing a comprehensive picture of compliance costs and other direct costs. For example, the Proposing Release acknowledges that there may be direct costs to funds that utilize a pass-through expense model as those funds are required "to re-structure their fee and expense model."[95] These costs associated with restructuring the fund's expense model will aggregate with the direct costs of compliance with other proposed rules which impact that fund. Those costs must be considered jointly and in the context of the direct costs of the other proposed rules discussed above.

Respectfully submitted,



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April 25, 2022

[95] Proposing Release, p. 141, footnote 157.