CITADEL

May 3, 2022

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

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (File No. S7-18-21)

Dear Ms. Countryman:

We appreciate the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on the proposal to overhaul the regulatory framework for private funds (the "Proposal").[1]

Citadel is a leading investor in the world's financial markets, managing in excess of $50 billion in investment capital on behalf of a diverse array of investors, including pensions (local, corporate, and union), endowments, healthcare providers, foundations, and insurance companies. Founded in 1990, our flagship fund has delivered a 19.3% annualized return since inception, returns that help our investors fund innovative research, support leading academic institutions, and secure the retirement futures of their beneficiaries. The strong partnership with our investors is exemplified by the fact that our 15 largest investors have entrusted us with their capital for approximately 13 years on average.

Longstanding Commission rules issued pursuant to the Investment Advisers Act of 1940 (the "Advisers Act") have fostered a vibrant ecosystem of private funds competing to generate investment returns for sophisticated investors. However, without statutory authority or any rational basis, the Commission now proposes to drastically overhaul these rules, invalidating negotiated arrangements that have been in place between sophisticated parties for decades, and in doing so, imperiling the ability of fund managers to deliver long-term, sustainable, and superior risk-adjusted returns for investors.

Several themes pervade various aspects of this Proposal:

- **The Commission seeks to substitute its judgment for that of sophisticated investors**. This paternalistic approach is evident throughout the Proposal, with the Commission claiming that "it may be hard even for sophisticated investors with full and fair disclosure, to understand the future implications of terms and practices."[2] Instead, the Commission now seeks to impose its own view as to permissible commercial terms by prohibiting specific types of fee and expense models, overriding contractually-agreed standards of liability, and generally disregarding the heavily negotiated arrangements between fund

[1] 87 Fed. Reg. 16886 (Mar. 24, 2022), https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf.

[2] *Id.* at 16937.

managers and sophisticated investors.

In doing so, the Commission proposes new standards that are often *more onerous than those applicable to funds catering to retail investors*, upending longstanding Commission precedent and broader principles deeply embedded in the securities laws without any rational basis for doing so. Over 80 years of securities law (including federal case law) has treated the Advisers Act as a disclosure-based regulatory regime appropriate for sophisticated investors, in contrast to the Advisers Act's companion statute, the Investment Company Act, which adopts a more prescriptive rules-based approach for investment companies catering to retail investors.[3] Notably, the U.S. Supreme Court has stated that "the evident purpose of the Investment Advisers Act of 1940 [is] to substitute a philosophy of *disclosure* for the philosophy of caveat emptor."[4] The current Proposal ignores this precedent in an inappropriate attempt to transform the Advisers Act into a prescriptive framework with new standards that are more onerous than those applicable to funds catering to retail investors.

- **The Commission lacks statutory authority for many of the proposed changes**. The Advisers Act does not provide the Commission with the authority to prohibit specific types of fee and expense models, discard contractually-agreed standards of liability, or impose extensive and prescriptive fee, expense, and portfolio reporting obligations. To support this proposal, the Commission frequently cites enforcement cases against private funds that have little to no relation to the proposed rulemaking.[5] In particular, these cases involve behavior already prohibited by the Commission's existing set of rules. For example, many of the cited enforcement cases focus on private fund advisers charging fees and expenses that *were not disclosed* to private fund investors.

- **The Proposal will have unjustifiable impacts on efficiency, competition, and capital formation.** The Commission's economic analysis incorrectly assumes that the Proposal will set the optimal terms for private fund investors,[6] lower the costs charged by private

[3] *See, e.g.*, *SEC v. Cap. Gains Rsch. Bureau, Inc.*, 375 U.S. 180, 194 (1963); Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72054, 72080 (Dec. 10, 2004); *see also* Andrew J. Donohue, Former Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Keynote Address at the 9th Annual International Conference on Private Investment Funds (Mar. 10, 2008), https://www.sec.gov/news/speech/2008/spch031008ajd.htm ("The approach we have taken in the United States to regulating investment advisers resembles in many respects the principles-based approach to regulation here. When enacting the Investment Advisers Act of 1940, Congress recognized the diversity of advisory relationships and through a principles-based statute provided them great flexibility, with the overriding obligation of fiduciary responsibility. Congress chose not to subject registered advisers to a 'fit and proper' test.").

[4] *See Cap. Gains Rsch. Bureau, Inc.*, 375 U.S. at 199 (emphasis added). *See also Goldstein v. SEC*, 451 F.3d 873, 876 (D.C. Cir. 2006) (citing *Capital Gains Research Bureau, Inc.* and noting that "the Advisers Act is mainly a registration and anti-fraud statute").

[5] *See* Proposal at 16887-90, 16892, 16927, 16937, 16945.

[6] *Id.* at 16943.

fund advisers,[7] enhance overall investor returns,[8] and induce new private fund advisers to enter the market.[9] In reality, departing from the Commission's well-established focus on disclosure and informed consent, and tearing up negotiated arrangements between private fund managers and sophisticated investors, will likely increase advisers' costs, reduce investor returns, and create new barriers to entry that decrease overall market competition and investor choice. The Commission makes no attempt to assess this impact beyond a terse acknowledgement that the Proposal "does not preclude fund advisers from responding by raising prices of services."[10] In addition, the Commission often fails to distinguish between different types of private funds (i.e. closed-end and open-end funds, or hedge funds and private equity funds) in its analysis, even though the redemption rights afforded investors in open-end funds further ensure an ongoing alignment of interests.

These costs of the Proposal are far from theoretical. For example, (a) aspects of Citadel's current fee and expense model may be directly impacted, potentially leading to a restructuring of arrangements that have enabled our flagship fund to deliver a 19.3% annualized return since its inception more than 30 years ago, (b) the standard of liability negotiated with our investors would also be overridden, resulting in Citadel bearing material increased risks as an adviser, and (c) Citadel would be required to disclose extensive and commercially sensitive information for each fund and to build an infrastructure and process in order to generate that information. Each of these elements of the Proposal should be expected to increase overall costs and reduce investor returns.

Below, we detail why the Proposal will negatively impact market efficiency, competition, and capital formation, lacks a rational basis, and is inconsistent with the Advisers Act.

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[7] *Id.* at 16956.

[8] *Id.*

[9] *Id.*

[10] *Id.* at 16943.

TABLE OF CONTENTS

I. Prohibiting Advisers From Charging Regulatory Or Compliance-Related Fees And Expenses Is Unsupported By Law Or Policy And May Counterintuitively Alter The Incentives Of Advisers Who Significantly Invest In Compliance Functions.

The Proposal prohibits advisers from charging a private fund for (a) any regulatory or compliance fees or expenses of the adviser or its related persons and (b) any fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority. Singling out these specific expense items from the broader set of reimbursable expense items was a curious decision that raises more questions than answers, and may alter the incentives of advisers who currently make significant investments in compliance functions.

This proposed prohibition would represent a particularly disruptive change for pass-through funds, such as Citadel, which allocate to the funds the actual operating expenses associated with acting as an adviser (including regulatory and compliance expenses).[11] As a result of being prohibited from passing on certain types of expenses to investors, Citadel would be compelled to consider restructuring the longstanding economic arrangements that have served our investors incredibly well for decades.

As detailed below, the Commission does not articulate a reasoned basis for this prohibition, fails to adequately consider the associated costs for advisers and investors, and lacks the statutory authority to prohibit a specific type of fee model fully disclosed to, and agreed by, sophisticated investors.

A. The Commission Did Not Adequately Assess The Economic Consequences Of The Proposal And Failed To Adequately Consider Reasonable Alternatives.

The Commission's analysis of the economic impact of prohibiting advisers from passing-through regulatory, compliance, and examination-related expenses of the adviser is clearly insufficient. The Proposal posits that the end result will be (i) fewer charges borne by investors, which could increase returns, and (ii) less excessive risk-taking by advisers, since they will have to bear the cost of any ensuing examinations or investigations.[12] However, in reality, advisers would have two options:

- obtain reimbursement for regulatory, compliance, and examination-related expenses through introducing (or increasing) a management fee, which would eliminate all of the purported benefits above; or

- bear the increased costs resulting from the Proposal, which would create an incentive for advisers to (i) under-invest in regulatory and compliance functions[13] and (ii) avoid

[11] We note expenses of the adviser that are entirely unrelated to the services the advisor provides to the funds are excluded.

[12] Proposal at 16948.

[13] *Id.* at 16949. To our knowledge, this is the first time the Commission has proposed a rule that it acknowledges may result in "an increase of compliance risk." *Id.*

expanding into new investment strategies, asset classes or geographies, or discontinue certain investment strategies (or particular investments therein).

Both of these outcomes are harmful to investors and would likely reduce overall returns. For example, requiring advisers to restructure economic arrangements that have contributed to delivering long-term, sustainable, and superior returns will almost certainly lead to higher costs for investors. In turn, altering adviser incentives with respect to appropriately investing in compliance functions (e.g. hiring fewer internal legal and compliance professionals, and spending less on outside advice and on compliance-related software) would also be harmful to investors. The Commission specifically acknowledges this risk in the Proposal, stating: "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 in order to reduce costs, which may be to the detriment of the fund's performance or lead to an increase of compliance risk," further underscoring the ill-considered nature of this aspect of the Proposal. More generally, by favoring the management fee model over the pass-through expense model, without any reasoned basis for doing so,[14] the Commission is specifically targeting funds that have delivered long-term, sustainable, and superior returns to investors. All of these outcomes negatively impact market efficiency, competition, and capital formation, and are directly contrary to the interests of investors.

Without more explanation from the Commission, it is difficult to ascertain the policy concerns driving this aspect of the Proposal, but there are certainly more reasonable alternatives that the Commission failed to consider. For example, if the Commission is concerned about increasing investor transparency of pass-through expense arrangements, then it should have considered the expected impact of the Proposal's separate requirements for private funds to prepare detailed quarterly disclosure statements regarding, among others, fees and expenses.[15] If the Commission is concerned about investors bearing the costs of adviser settlements or penalties for wrongdoing, the Commission has the authority today, as a condition of the settlement, to require the adviser, rather than the fund, to bear the costs associated with a settlement or penalty. This means that the Proposal cannot be premised on a need to prevent funds from passing-through the costs of settlements or penalties for wrongdoing. The Proposal, therefore, creates the impression that it is actually targeting the ability of advisers to demonstrate to the Commission, whether through examination or investigation, that they have *complied* with applicable rules and regulations; a seemingly incongruous outcome.

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[14] *See generally* Andrew Weiss, *Would Hedge Fund Investors Benefit From Paying Operating Expenses?*, 13 J. of Investing 91 (2004). We note the Commission considered providing an exception from the prohibition for pass-through funds, but rejected it due to the risk that an exception "would continue to subject the fund to an adviser's incentive to shift its fees and expenses to the fund to reduce its overhead and operating costs." Proposal at 16959. But that is precisely the economic arrangement agreed with sophisticated investors—the actual operating expenses associated with acting as an adviser (including regulatory and compliance expenses) are allocated to the fund rather than solely relying on a management fee.

[15] We note that the Institutional Limited Partners Association ("ILPA") has found that "clear and consistent reporting of fees and expenses is an area that has seen real progress." ILPA, *Key Findings ILPA Industry Intelligence Report "What is Market in Fund Terms?"* (2021), https://ilpa.org/wp-content/uploads/2021/10/Key-Findings-Industry-Intelligence-Report-Fund-Terms.pdf. We also note the Commission confusingly asserts that greater transparency is not a viable alternative 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," without explaining how detailed transparency requirements regarding fees and expenses would result in "obscured payments." Proposal at 16959.

Instead of considering more reasonable alternatives, the Commission elected to propose a broad and radical prohibition on the ability of advisers to pass-through certain select expenses to investors. In doing so, the Commission failed to consider the ramifications for pass-through funds and their investors, and the overall impact of a higher management fee (which would not be a transitory expense as the Commission alleges), less transparency and choice for investors, and new barriers to entry for advisers.

B. The Commission Lacks A Rational Basis For The Proposal.

The Commission seeks to justify the proposed prohibition by alleging that the pass-through of regulatory, compliance, and examination-related expenses of the adviser creates a conflict of interest between the adviser and the fund, such that an adviser may "place its own interests ahead of the private fund's interests and unfairly allocate expenses to the fund, even where fully disclosed."[16] As noted above, singling out these specific expense items from the broader set of reimbursable expense items was a curious decision. All advisers endeavoring to operate in a compliant manner will incur significant regulatory, compliance, and examination-related expenses given the highly-regulated nature of the asset management industry, and it is not inappropriate, nor is it inherently fraudulent or deceptive, for the adviser to be reimbursed for those costs in a manner that aligns the adviser's incentives with those of its investors. It is nonsensical for the Commission to suggest that regulatory, compliance, and examination-related expenses incurred by the adviser in order to *comply* with Commission rules and regulations are not in the best interests of investors.

The strong alignment of interests between advisers and investors with respect to regulatory, compliance, and examination-related expenses incurred by the adviser is evident in pass-through funds. First, the adviser is a fiduciary of the fund, with a duty of care and duty of loyalty, and exists to act in the fund's best interests. This strong alignment of interests is exemplified at Citadel, where investments from principals and employees of the adviser account for over 20% of total assets under management.[17] In addition, Citadel's principals and employees pay the same fees and expenses as third-party investors. The suggestion that the adviser and the fund have conflicting interests is simply inaccurate.

Second, in the midst of a fiercely competitive industry, with overall adviser fees declining,[18] investors continue to select funds with pass-through expense models, many of which pursue a dynamic multi-strategy investment approach, given the associated transparency, performance, and alignment of interests. This structure enables the adviser to dynamically and continuously invest in the necessary regulatory and compliance personnel, technology, and infrastructure to deliver long-term, sustainable, and superior risk-adjusted returns.

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[16] *Id.* at 16922.

[17] Investments by "principals and employees" include, but are not limited to, investments related to Citadel's employee incentive program on behalf of current and former employees, and also include investments from partners (including from estate-related entities) and their families.

[18] Leslie Picker, *Two and twenty is long dead. Hedge fund fees fall further below onetime industry standard*, CNBC (June 28, 2021), https://www.cnbc.com/2021/06/28/two-and-twenty-is-long-dead-hedge-fund-fees-fall-further-below-one-time-industry-standard.html.

Third, in open-end funds, such as the Citadel funds, investors have the ability to redeem to the extent they are unsatisfied with how (and how much) operating expenses are being allocated to the funds in practice. Most of the multi-strategy funds with pass-through expense models are open-end funds. The Commission fails to acknowledge this important feature, which further ensures an ongoing alignment of interests. In Citadel's case, notwithstanding the option to redeem, our 15 largest investors have entrusted us with their capital for approximately 13 years on average.

The Commission ignores the strong alignment of interests created by the pass-through expense model, and the resulting returns delivered to investors, and instead proposes to constrain investor choice by prohibiting advisers from passing-through regulatory, compliance, and examination-related expenses. In doing so, the Commission appears particularly focused on restricting *the manner* in which these expenses are reimbursed by investors, as the Commission specifically acknowledges that advisers would still be permitted to obtain reimbursement for regulatory, compliance, and examination-related expenses through a management fee.[19] Permitting the same expenses to be reimbursed through a management fee, but not through a fully disclosed pass-through arrangement where investors are made aware of the actual costs incurred,[20] lacks any rational basis and only serves to reduce investor transparency and choice, as pass-through funds will be compelled to consider restructuring the longstanding economic arrangements that have served investors incredibly well.

More generally, by subjecting regulatory, compliance, and examination-related expenses to disparate treatment, the Commission is requiring all private funds to isolate and separately track these expenses in order to comply with the Proposal. We are only left to speculate as to the Commission's motivations for targeting these particular expense items; discouraging investment in compliance functions should not be the end-result sought by the Commission and an established and widely-accepted compensation model should not be upended by the Commission without a more thorough analysis.

C. The Commission Lacks Statutory Authority.

The Commission's proposal to prohibit private fund advisers from charging fully disclosed regulatory and compliance fees to sophisticated investors far exceeds the Commission's statutory authority.

1. The Commission's proposal conflicts with the entire regulatory framework that Congress established for governing private funds. In the Investment Company Act, Congress set forth detailed rules governing almost every aspect of investment companies' operations,[21] but explicitly

[19] Proposal at 16948.

[20] Remarkably, the Commission claims that having investors reimburse the adviser for regulatory, compliance, and examination-related expenses through an overarching management fee "would be more transparent" than through a fully disclosed pass-through arrangement where investors are made aware of the actual costs incurred. *Id.* The Commission provides no support for this assertion.

[21] *See* 15 U.S.C. §§ 80a-1 *et seq.*

exempted private funds from that scheme.[22] This private-fund exemption represented Congress's judgment that the large, highly sophisticated investors who invest in private funds (so-called "qualified purchasers") are able to bear and appreciate the risks associated with their investments, and—in Congress's words—to "evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights."[23] The Commission's proposal directly conflicts with Congress's judgment. Rather than allowing sophisticated private fund investors to negotiate favorable terms with private fund advisers, the Commission paternalistically proposes to eliminate a number of widely accepted, longstanding private fund arrangements.

The Commission cites Sections 211(h) and 206(4) of the Advisers Act as the sources of authority for the proposed rule, but neither section provides the "clear congressional authorization" one would expect for such a "transformative expansion" of the Commission's authority into the innerworkings of private funds.[24]

2. Section 211(h) does not authorize the proposed rules. Section 211(h) authorizes the Commission to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."[25] This section constrains the Commission's authority in two ways: the proposed rule must seek to regulate or restrict "certain sales practices, conflicts of interest, and compensation schemes," and the rule must be in the public interest and needed for the protection of investors. The Commission's proposal fails on both counts.

First, the proposed prohibition on charging certain regulatory and compliance fees does not regulate "certain sales practices, conflicts of interest, and compensation schemes" within the meaning of Section 211(h). Read in "context and with a view to their place in the overall statutory scheme,"[26] the words "sales practices," "conflicts of interest," and "compensation schemes" must be understood in the context of an advisory relationship and the dynamics that exist between a principal and its agent. These terms are all interrelated,[27] and the concept of an advisory relationship is the glue holding them together. As the Commission has explained elsewhere, certain forms of "compensation"—such as sales contests—create "conflicts" whereby employees of investment advisers and broker-dealers face "high-pressure situations" to engage in aggressive "sales conduct" to push retail investors into non-suitable transactions.[28] These concepts have no application here, where the Commission seeks to regulate not the way in which advisers go about

[22] *See id.* § 80a-3(c)(7)(A).

[23] Prohibition of Fraud By Advisers of Certain Pooled Investment Vehicles, Securities Act Release No. 8766, 2006 WL 3814994, at *8 n.45 (Dec. 27, 2006) (quoting S. Rep. No. 293, 104th Cong. 2d Sess. 10 (1996)).

[24] *Util. Air Regulatory Grp. v. EPA*, 573 U.S. 302, 324 (2014).

[25] 15 U.S.C. § 80b-11(h)(2).

[26] *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000).

[27] *See Bullock v. BankChampaign, N.A.*, 569 U.S. 267, 274 (2013) (explaining that nearby statutory words refer to "generally similar" things).

[28] Regulation Best Interest, 84 Fed. Reg. 33318, 33396 (July 12, 2019).

soliciting investments on behalf of their advisory clients, but the terms of investments negotiated at arms' length between highly sophisticated counterparties. Section 211(h) does not reach this far outside the relationship between advisor (or broker-dealer) and client.

The word "certain" preceding "sales practices, conflicts of interest, and compensation schemes" underscores the limited reach of Section 211(h). It confirms that Congress was "concerned with certain" practices "only, not with all" the issues that could even conceivably be lumped into the sales practices, conflicts of interest, and compensation schemes buckets.[29]

Indeed, if Congress really intended to empower the Commission to prohibit the charging of certain fees, it would have said so explicitly. The securities laws are replete with examples of Congress authorizing the Commission to regulate fees.[30] These provisions would be a nullity if the Commission's expansive reading of Section 211(h) were correct—if that provision broadly authorized the Commission to prohibit or restrict brokers, dealers, and investment advisers from charging certain fees. Such a broad reading must be rejected to avoid "the superfluity" that would result from allowing the "specific" fee-regulation provisions Congress has enacted to be "swallowed by the general" authorization the Commission sees in Section 211(h).[31]

The Commission's broad reading of Section 211(h) creates tension with other aspects of the statutory structure as well. In multiple parts of Section 211, Congress provided that a private fund adviser's client is the private fund itself—*not* investors in the private fund.[32] These provisions, all neighboring Section 211(h), preclude the Commission from reading Section 211(h) so broadly that it permits the Commission to treat private fund investors as if they were the clients being advised by the advisers. They are not, as the D.C. Circuit has made clear.[33] Private fund investors are highly sophisticated entities that negotiate at arms' length with advisers. Congress did not intend for them to be regulated as if they were the adviser's customers.

The history of Section 211(h) further confirms that the Commission's reading is too broad. Section 211(h) was added to the Advisers Act as part of Section 913(g) of the Dodd Frank Act. That provision is entitled "Authority to Establish a Fiduciary Duty for Brokers and Dealers," and it is focused on granting the Commission the power to establish a standard of conduct as to retail customers. Section 913(g), for example, requires the Commission to conduct "a study" of existing standards of care for brokers, dealers, and investment advisers when "providing personalized investment advice and recommendations about securities to retail customers" and to evaluate the

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[29] *El Al Israel Airlines, Ltd. v. Tsui Yan Tseng*, 525 U.S. 155, 173 (1999).

[30] *See, e.g.*, 15 U.S.C. § 80a-17(e)(2) (barring a person "acting as a broker" from receiving a certain type of "commission, fee, or other remuneration . . . unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission").

[31] *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645 (2012).

[32] *See* 15 U.S.C. § 80b-11(a) ("[T]he Commission may not define the term 'client' for purposes of paragraphs (1) and (2) of section 80b-6 of this title to include an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser."); *id.* § 80b-11(g) ("[T]he Commission shall not ascribe a meaning to the term 'customer' that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contact with such adviser.").

[33] *See Goldstein*, 451 F.3d 873.

need to fill any "gaps" in the "legal or regulatory standards" relevant to "the protection of retail customers."[34] That section likewise authorizes the Commission to "commence a rule-making, as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care … for providing personalized investment advice about securities to such retail customers."[35] Against this backdrop, it is difficult to believe that Section 211(h)—an ancillary provision titled "Other Matters"[36]—was intended to reach far beyond the retail-investor context and authorize the Commission to force some of the world's largest, most sophisticated investors to restructure the terms of their investments in private funds. It is even more difficult to believe that Congress intended to confer such a sweeping power in Section 211(h) without any legislative debate whatsoever. Congress did not hide that "elephant" in the "mousehole" of Section 211(h).[37]

Second, and in any event, the proposed prohibition on charging for regulatory and compliance fees independently exceeds the Commission's authority because it is not in the "public interest" or needed for the "protection of investors."[38] As discussed, the investors in private funds are large, highly sophisticated entities. The Commission does not—and cannot—show that these entities are in need of additional regulatory protections. Nor can the Commission show that the charges they attempt to prohibit are contrary to the public interest. Quite the opposite: when an adviser is able to pass on its regulatory and compliance costs to investors, the adviser is incentivized to invest in compliance.[39] That is in investors' (and the public's) best interests, which is presumably why many of the world's largest, most sophisticated investors choose the pass-through model for their private fund investments.

3. Section 206(4) also fails to authorize the proposed rules. Section 206(4) directs the Commission to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[40] The proposed prohibition on charging regulatory and compliance fees exceeds this authority in two respects. *First*, the Commission has made no attempt to "define" certain "practices . . . as [ ] fraudulent." Moreover, it is counterintuitive for the Commission to contend that spending on regulatory compliance is somehow more likely to be fraudulent, deceptive, or manipulative than other types of expenses. And, *second*, even if it had, the Commission could not show that the proposed rules actually target the fraudulent conduct. "Fraud" is the "knowing misrepresentation or knowing concealment of a material fact made to induce another to act to his or her detriment."[41] Section 206(4) does not authorize the Commission to prohibit *fully disclosed* contractual arrangements between sophisticated investors. The Commission's proposal plainly sweeps too broadly.

[34] Dodd Frank Act § 913(b)-(c).

[35] *Id.* § 913(f).

[36] *Id.* § 913(g).

[37] *Util. Air Regulatory Grp.*, 573 U.S. at 324.

[38] 15 U.S.C. § 80b-11(h)(2).

[39] Overdahl Report ¶ 25.

[40] 15 U.S.C. § 80b–6(4).

[41] *Fraud*, *Black's Law Dictionary* (11th ed. 2019).

That the Commission thinks certain costs "*should* be borne by the adviser," or that it would be "unfair[ ] [to] allocate" certain expenses "to the fund, *even where fully disclosed*," is irrelevant.[42] The Commission is authorized to prevent fraud, not restructure the contractual relationships negotiated at arms' length between highly sophisticated counterparties just because the Commission thinks a different structure would be better.

4. The proposed rule also raises serious constitutional concerns. The Supreme Court has long warned that the First Amendment "directs us to be skeptical of regulations" that seek to deprive individuals "of accurate information about their chosen products,"[43] yet that is exactly what the proposed rules would do. The Commission *admits* that the prohibition on charging regulatory and compliance fees will not actually prohibit firms from charging those fees; firms will just "restructur[e]" their models to charge the fees in less efficient ways—for example, as part of a larger fixed management fee.[44] The only thing the proposal will do is keep advisers from directly passing-through regulatory and compliance fees to investors. This proposal thus seems to be targeted less at actual conduct, and more at keeping investors in the dark as to the true costs of compliance. The Commission should avoid this constitutional concern.[45]

II. Prohibiting Advisers From Seeking Indemnification For Negligence Is Unsupported By Law Or Policy.

The Proposal prohibits advisers from seeking reimbursement, indemnification, exculpation, or limitation of their liability for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to a private fund. This would represent a significant departure from current market practice, where indemnification clauses are directly negotiated with sophisticated investors and private fund advisers are often indemnified except in the event of gross negligence or reckless or intentional misconduct. As a result, advisers would face significantly increased liability risks in carrying out day-to-day operations and investment management services—risks that may even exceed those for advisers who manage assets for retail investors.

As detailed below, the Commission does not articulate a reasoned basis for its reversal of longstanding Commission policy, fails to adequately consider the associated costs for advisers and investors, and lacks the statutory authority to establish a common liability standard across the private fund industry.

A. The Proposal Represents An Unjustified Reversal Of Longstanding Commission Policy.

The Commission has historically distinguished between retail investors and sophisticated investors when calibrating the regulatory framework. For example, the Commission has held that

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[42] Proposal at 16922 (emphases added).

[43] *44 Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 503 (1996).

[44] Proposal at 16949.

[45] *Cf. Solid Waste Agency of N. Cook Cty. v. U.S. Army Corps of Eng'rs*, 531 U.S. 159, 174 (2001) (construing an authorizing statute "to avoid the significant constitutional . . . questions raised" by the agency's "application of [its] regulations").

sophisticated "accredited investors" have "the knowledge and expertise to participate in our private capital markets and therefore do not need the additional protections of registration under the Securities Act of 1933," while retail investors are considered to require additional regulatory protection and thus are barred from participating in private markets.[46]

Similarly, the Commission has acknowledged this distinction as relevant when considering the duties and obligations of investment advisers. Less than three years ago, the Commission issued a formal interpretation regarding the standard of conduct for investment advisers (the "Standard of Conduct Interpretation"), which specifically addressed, among other issues, indemnification clauses. In particular, the Commission noted that the obligations of an adviser to a retail client will be "significantly different" from those of an adviser to a private fund and that the sophistication level of the client is relevant in determining whether an indemnification clause is consistent with the Advisers Act.[47] A "facts and circumstances" analysis is applied to indemnification clauses negotiated with sophisticated clients, and although an adviser's federal fiduciary duty cannot be waived, it can be "shaped by agreement."[48] In addition, the Commission refrained from taking any position "on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law."[49]

This Proposal radically reverses the Standard of Conduct Interpretation. The Commission, through this Proposal, has now determined that the sophistication level of the client is no longer relevant in determining whether a negotiated indemnification clause is consistent with the Advisers Act; instead, the Commission prescribes exactly what constitutes an acceptable indemnification clause for the entire private fund industry. Remarkably, by referencing negligence instead of gross negligence, the Commission-prescribed indemnification clause sets a more onerous standard of liability for advisers of private funds than for advisers of registered investment companies ("RICs"), which cater to retail investors.[50] As a result, the Commission's longstanding distinction between retail investors and sophisticated investors is completely upended.

The Commission fails to provide a credible or even rational basis for reversing the Standard of Conduct Interpretation and for setting a more onerous standard of liability for advisers of private

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[46] Amending the "Accredited Investor" Definition, 85 Fed. Reg. 2574 (Jan. 15, 2020), https://www.govinfo.gov/content/pkg/FR-2020-01-15/pdf/2019-28304.pdf.

[47] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33669, 33672 & n.31 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.

[48] *Id.* at 33672 n.31.

[49] *Id.*

[50] *See* Section 17(i) of the Investment Company Act of 1940 (codified at 15 U.S.C. § 80a-17(i)) ("no contract or agreement under which any person undertakes to act as investment adviser of, or principal underwriter for, a registered investment company shall contain any provision which protects or purports to protect such person against any liability to such company or its security holders to which he would otherwise be subject by reason of **willful misfeasance, bad faith, or gross negligence**, in the performance of his duties, or by reason of his **reckless disregard** of his obligations and duties under such contract or agreement" (emphases added)).

We also note that we assume the Commission-prescribed indemnification clause does not intend to preclude private fund advisers from seeking to limit liability associated with any fiduciary duty that applies to an adviser under applicable state law. A different interpretation would represent a further reversal of the Standard of Conduct Interpretation and would raise additional questions regarding the Commission exceeding its statutory authority.

funds than for advisers of RICs. Even more concerning, the Commission omits to acknowledge these glaring inconsistencies. The Standard of Conduct Interpretation is cited a total of three times in the Proposal, with no acknowledgment that the Proposal is in direct conflict with this recent Commission Interpretation. In turn, the Proposal does not compare the Commission-prescribed indemnification clause for private fund advisers with the parallel requirements that apply to RICs.

Indeed, the sole rationale for overriding contractual provisions negotiated by private fund managers and sophisticated investors appears to be the Commission's own dislike for these provisions. The Proposal does not include (a) any allegation that these negotiated contractual provisions are not fully disclosed, (b) any evidence of harmful outcomes to investors resulting from the operation of these provisions, (c) any explanation as to why the Commission is proposing a standard of liability based on negligence instead of gross negligence (which is the relevant standard for advisers of RICs),[51] or (d) any third-party support for a private fund adviser standard of liability based on negligence.[52]

B. The Commission Did Not Adequately Assess The Economic Consequences Of The Proposal.

The Commission's analysis of the economic impact of its newly-prescribed indemnification clause is completing lacking: investors purportedly will benefit as there will be fewer scenarios where adviser reimbursement will be required and advisers will be less likely to engage in malfeasance as a result.[53] Like many of the prohibitions contained in the Proposal, the Commission has presented a conclusion in search of a justification. There is no discussion as to why the Commission elected to propose a standard of liability based on negligence instead of gross negligence or the economic implications of such a significant and unprecedented restriction on the ability of sophisticated parties to freely define the parameters of their relationship.

We are unaware of any other example of government regulation prohibiting sophisticated parties from receiving indemnification for negligence. Such a restriction would significantly increase the liability risks for advisers in the ordinary course of acting on behalf of a private fund. For example, it is conceivable that advisers could suddenly be liable for simple trade errors or ministerial mistakes made by employees. This additional legal exposure would increase advisers' costs (including insurance-related expenses), and may result in the curtailment of more complex investment strategies (or investments therein), all of which should be expected to reduce investor returns, increase costs, and create new barriers to entry that decrease overall market competition and investor choice. The Commission cannot subject advisers to greatly increased legal exposure with no justification or analysis, and then assume, for purposes of its economic analysis, that there would be no impact on adviser fees (or investor returns) as a result.

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[51] Instead of explaining why the Commission chose "negligence" as the standard, the Proposal asks market participants to do the required analysis. Proposal at 16925 ("Should this aspect of the final prohibited activities rule prohibit limiting liability for 'gross negligence,' or would prohibiting limitations of liability for ordinary negligence, as proposed, be more appropriate? Why?").

[52] We note the cited ILPA comment letter does not express support for a private fund adviser standard of liability based on negligence. Proposal at 16925 n.170.

[53] *See id.* at 16951.

C. The Commission Lacks Statutory Authority.

The Commission's proposal to prohibit private fund advisers from seeking indemnification for negligence fails for the same reason as the Commission's proposal to ban the charging of regulatory or compliance fees: Congress never authorized the Commission to do that. The Commission again points to Sections 211(h) and 206(4) as the sources of the authority for the proposed rule, but, again, those sections do not grant the authority the Commission claims.

1. Section 211(h) does not authorize the proposed rule. As discussed above, that section authorizes the Commission to prohibit or restrict "certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."[54]

Section 211(h) does not help the Commission because an indemnification agreement is not a "sales practice," "conflict of interest," or "compensation scheme" within the meaning of Section 211(h). As explained, the words "sales practices," "conflicts of interest," and "compensation schemes" must be understood in the context of an advisory relationship and the dynamics that exist between a principal (such as a private fund) and its agent (the adviser).[55] Those words do not reach the terms of an investment contract negotiated between sophisticated counterparties *at arms' length*.

Even at their broadest possible reading—well outside the context of Section 211(h)—the words "sales practices," "conflicts of interest," and "compensation schemes" fail to support the proposed rule. An indemnification clause is not a mode or method of making sales (a "sales practice"), such as cold calling.[56] Nor is it an arrangement to provide "[r]emuneration or other benefit[s]" in exchange for "services rendered" (a "compensation scheme").[57]

The indemnification clause is not a conflict of interest either. Conflicts of interest arise in principal-agent relationships, not in arms-length negotiations.[58] Moreover, an indemnification clause only addresses a private cause of action; it does not (and cannot) waive the fiduciary duty created by the Advisers Act and enforced by the Commission.[59] In addition, an indemnification clause incentivizes *efficient* behavior. The entire reason private fund investors select funds with indemnification clauses is because the indemnity encourages appropriate risk taking.[60] The Commission cannot outlaw that option without addressing and justifying the predictable impact

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[54] 15 U.S.C. § 80b-11(h)(2).

[55] *Supra* at 8.

[56] *See A.S. Goldmen & Co.*, Exchange Act Release No. 47,037, 2002 WL 31840963, at *2 (Dec. 19, 2002) (sales practices include an "aggressive cold-calling campaign").

[57] *Compensation*, *Black's Law Dictionary* (11th ed. 2019).

[58] *See* Regulation Best Interest, 84 Fed. Reg. at 33319 ("Like many principal-agent relationships, the relationship between a broker-dealer and a retail customer has certain inherent and unavoidable conflicts of interest.").

[59] *See, e.g.*, *Robare Grp. v. SEC*, 922 F.3d 468 (D.C. Cir. 2019).

[60] Overdahl Report ¶ 47.

on the superior returns that are a principal reason the world's largest investors turn increasingly to private funds.

More generally, the Commission's attempt to locate in Section 211(h) an expansive power to bar indemnification agreements cannot be squared with Congress's treatment of indemnification agreements in other contexts. For one, when Congress intends to bar indemnification provisions, it does so expressly.[61] For another, Congress has already spoken on the issue of indemnification agreements in the context of RICs—funds that have *retail investors*. In that context—the retail investor context—Congress determined that funds could not seek indemnification for "gross negligence" or worse.[62] It makes no sense that Congress would have authorized the Commission to hold *private funds*—funds with large, highly sophisticated investors—to a higher standard, one that bars indemnification for even simple negligence. The Commission has not explained this seemingly inexplicable discrepancy.

Regardless, the proposed rule fails for a second reason: it is not in the "public interest" or needed for the "protection of investors."[63] As detailed above, the large, highly sophisticated investors in private funds do not need protection from fully disclosed terms.[64] Nor is barring those contractually-agreed terms in the public interest. As explained, indemnification encourages the appropriate entrepreneurial spirit in private fund advisers, and investors are better off when they have the freedom to choose this type of arrangement.[65]

2. Section 206(4) also does not authorize the proposed rules. As explained above, Section 206(4) directs the Commission to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[66] Once again, the Commission fails to "define" certain "practices . . . as [ ] fraudulent." The Commission, likewise, is unable to show that the proposed rule actually targets fraudulent conduct because the indemnification clauses are fully disclosed. While a broad prohibition on indemnification clauses *might* be appropriate for retail investors, the Commission has made no showing that such a prohibition is needed in the context of private fund investors—investors who actively negotiate their agreements with representation by sophisticated counsel.

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[61] *See, e.g.*, 15 U.S.C. § 80a-17(i) (providing that "no contract or agreement under which any person undertakes to act as investment adviser of, or principal underwriter for, a registered investment company shall contain any provision which protects or purports to protect such person against any liability to such company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract or agreement"); 29 U.S.C. § 1110(a) (providing that, with some exceptions, "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy").

[62] *See* 15 U.S.C. § 80a-17(i).

[63] *Id.* § 80b-11(h)(2).

[64] *Supra* at 7-8.

[65] Overdahl Report ¶ 47; *supra* at 12-14.

[66] 15 U.S.C. § 80b–6(4).

III. The Commission Has No Basis For Adopting The Quarterly Reporting Requirement.

The Proposal requires private fund advisers to prepare quarterly statements for investors within 45 days that include information regarding (i) compensation paid to the adviser and its related persons (with separate line items for management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation), (ii) other fees and expenses paid by the fund (with separate line items for organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses), and (iii) fund performance.

The granularity of this proposed disclosure, and the timeline in which it is to be provided, would impose significant costs on private fund advisers and investors that the Commission has failed to justify. More importantly, the decision to require such granular disclosure but not provide a comprehensive list of relevant line items to include in such disclosure, means that the Commission's objective of producing consistent and comparable disclosures across funds will not be realized. We urge the Commission to instead hew closely to the standardized disclosures (including, but not limited to, compensation, professional fees, management fees, performance fees, and investment returns) already provided by open-end funds in their audited financial statements.

A. The Commission Did Not Adequately Assess The Economic Consequences Of The Proposal And Failed To Adequately Consider Reasonable Alternatives.

The Commission asserts the main benefit of the Proposal is increased transparency for investors, but fails to demonstrate that open-end fund investors suffer from inadequate transparency today regarding fees, expenses, and performance.[67] In fact, the Proposal acknowledges that "many private fund advisers contractually agree to provide fee, expense, and performance reporting to investors"[68] and the Institutional Limited Partners Association has found that "clear and consistent reporting of fees and expenses is an area that has seen real progress."[69] The Commission made no attempt to review the investor disclosures provided by open-end funds in order to evaluate whether the Proposal would meaningfully increase transparency.[70] Instead, the Commission's cited evidence in support is largely limited to enforcement cases that are private equity focused and that only serve to demonstrate that current regulatory requirements are being vigorously enforced, not that the Commission has the basis to impose new regulation. For example, many of the enforcement cases cited focus on private fund advisers charging fees and expenses that *were not disclosed* to private fund investors.

[67] Proposal at 16947.

[68] *Id.* at 16890-91.

[69] ILPA, *Key Findings ILPA Industry Intelligence Report "What is Market in Fund Terms?"* (2021), https://ilpa.org/wp-content/uploads/2021/10/Key-FindingsIndustry-Intelligence-Report-Fund-Terms.pdf.

[70] We note the Commission merely asks "Would there be any overlap between the proposed quarterly statement and the existing quarterly account or similar statements currently prepared by advisers?" Proposal at 16896.

The Commission also asserts that the Proposal will increase standardization, enabling investors to more easily compare funds.[71] However, by requiring advisers to report separate line items for "each category of fee or expense"[72] without providing a comprehensive list of relevant line items, the Proposal will require subjective interpretations to be made by each adviser, resulting in less standardized disclosures than those currently provided to investors.

While the benefits appear largely illusory for open-end fund investors, the costs of the proposed disclosures are tangibly significant. Requiring overly granular disclosure regarding compensation and other key expenses of the adviser to be prepared quarterly and within 45 days of the end of the quarter creates a significant ongoing operational burden for fund advisers in order to ensure timeliness and accuracy. In both cases, the proposed requirements appear more onerous than those for advisers of RICs, which cater to retail investors.[73] It bears repeating that the Commission's longstanding distinction between retail investors and sophisticated investors is upended, as sophisticated investors now apparently warrant greater protections and more detailed and frequent disclosures than retail investors.

We urge the Commission to instead hew closely to the disclosures already provided by open-end funds in their audited financial statements, which are largely consistent with the existing requirements for RICs. For example, disclosures should be provided annually and no sooner than 60 days following the end of the reporting period. Fees and expenses should be grouped into a limited number of standardized categories, such as management fees, operating expenses, investment expenses, and income tax expenses. This approach would deliver standardized disclosures to investors while minimizing the associated burden on advisers and protecting commercially sensitive information.

B. The Commission Lacks Statutory Authority.

Like the proposed rules discussed above, the proposed quarterly reporting rule also exceeds the Commission's statutory authority.

The Advisers Act lays out in detail the reporting and disclosure obligations of investment advisers,[74] but, notably, the Commission does not appear to rely on any of those provisions to support the proposed rules—and for good reason: they do not apply. Section 211(h)(1), for example, is facially inapplicable because information like a fund's past performance and the fees ultimately paid by funds to advisers is not a "term" of the investors' "relationships with brokers, dealers, or investment advisers."[75] The *terms* of the relationship are set forth in the fund agreements establishing the investment relationship; these terms are not and cannot be set forth in

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[71] *Id.* at 16947.

[72] *Id.* at 16976 (Proposed § 275.211(h)(1)–2(b)(1) and (2)).

[73] *See* Section 29(e) of the Investment Company Act (codified at 15 U.S.C. § 80a-29(e)); Rule 30e-1 under the Investment Company Act (codified at 17 C.F.R. § 270.30e-1); Instruction A to Form N-PORT. Disclosures are required no more than semi-annually, reporting deadlines range from 60 to 120 days, and fees and expenses are grouped into three main categories (advisory fees, distribution fees and other expenses).

[74] *See, e.g.*, 15 U.S.C. §§ 80b-3(c)(1), 80b-4(b)(3), 80b-11(h)(1).

[75] *See id.* § 80b-11(h)(1).

disclosures provided after the fact. Disclosures that may "shape the terms of [the] relationship" are not themselves disclosures of "the terms" of that relationship.[76]

The Commission instead looks for statutory support in Section 206(4),[77] but that general anti-fraud authority does not authorize the proposed reporting rules. As an initial matter, the *general* language in Section 206(4) does not allow the Commission to sidestep the restrictions on the agency's authority imposed in the numerous statutory provisions that *specifically* address reporting and disclosure.[78] Furthermore, the Commission fails to connect the proposed reporting requirements to any actual fraudulent act. The Commission speculates that the proposed rule "*may* allow an investor to identify when the private fund is incorrectly, or improperly, assessed a fee or expense by the adviser contrary to the adviser's fiduciary duty or the fund's governing agreements or disclosures."[79] But the Commission does not explain *how* the proposed rule would stop a *deliberate fraud*, as opposed to inadvertent errors. Indeed, the bulk of the Commission's justification for the proposed reporting rule is aimed at helping investors to "better" "understand and monitor their private fund investments,"[80] an honorable aim—just one that has nothing to do with preventing fraud, the only regulatory objective that Congress authorized. An incidental impact on alleged fraud does not justify a provision that avowedly sweeps far more broadly.

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Please feel free to call the undersigned at (646) 403-8200 with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger
Managing Director
Global Head of Government & Regulatory Policy

[76] *See* Proposal at 16965 ("[E]nhanced disclosures would help investors shape the terms of their relationship with the adviser of the private fund.").

[77] *See id.* at 16976 ("*As a means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative*, an investment adviser that is registered or required to be registered under section 203 of the Investment Advisers Act of 1940 shall prepare a quarterly statement that complies with [the following requirements.]" (emphasis added)).

[78] *See, e.g.*, *RadLAX Gateway Hotel, LLC*, 566 U.S. at 645 (when a "general authorization and a more limited, specific authorization exist side-by-side," the "terms of the specific authorization must be complied with").

[79] Proposal at 16890 (emphasis added).

[80] *Id.*