

***PE Pathways* – Conversation With Former SEC Chief Economist Dr. Jessica Wachter on Investment Management Rulemaking at the Commission**

Speakers: Ben Mittman and Jessica Wachter

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Ben Mittman:

Welcome to *PE Pathways*, our podcast series where experienced dealmakers share their thoughts on current private equity and M&A trends and developments. I'm Ben Mittman. I'm a partner at Troutman Pepper Locke's Investment Funds practice. I'm really excited to have my friend Jessica Wachter join me and my fellow partner, Genna Garver.

Jessica is currently the Dr. Bruce I. Jacobs Professor in Quantitative Finance at the Wharton School at the University of Pennsylvania. From May 2021 to January 2025, she served as the Chief Economist at the SEC, as well as the Director of the Division of Economic and Risk Analysis at the commission. In that role, she led the 190-person division responsible for economic analysis in support of commission rulemaking, enforcement, and market oversight. During her tenure, the division contributed to over 100 rule proposals and adoptions, including initiatives aimed at improving the resiliency and transparency of U.S. financial markets. I think everyone generally agrees that, that was probably one of the most active ten years at the SEC in terms of rulemaking in perhaps decades.

Joining me as I mentioned is Genna. She's a partner with me in our Investment Funds practice and concentrates a lot of her time on advising our clients on private fund regulations and is a member of the Board of Directors of the National Association of Compliance Professionals and a member of its regulatory advisory committee. Thanks all for joining us. Jessica, why don't you kick it off? Maybe you can give for our listeners a little bit of your background and how Commissioner Gary Gensler came around once he was appointed by the Biden administration to reach out to you and to consider leaving Wharton to become the SEC's chief economist.

Jessica Wachter:

So first, thanks so much, Ben, for that kind introduction. So, I am a finance professor at Wharton. I have been here since 2003. So, Chair Gensler reached out to me in February 2021 about a possible role at the SEC, and it was a completely cold email. I was not expecting it. I had never met Chair Gensler before. I hadn't thought about serving in government or to the extent that I thought about it. I thought about it as something that I wasn't interested in doing. In fact, it took me a little while to respond to his email, which prompted a second email from Chair Gensler, or to be Chair Gensler, about why I hadn't responded. But I did respond to the second email, and it didn't take him long to change my mind about the possibility of serving. I actually told him within a few days that if I were to be his choice, I'd say yes, because I didn't want to waste this time. He had a lot going on then, in terms of becoming confirmed.

Ben Mittman:

Yes, I think generally, the legal community was anticipating a very robust and active agenda coming from Commissioner Gensler. The economic analysis role that you were being requested to perform was going to be a critical feature of that undertaking. Perhaps, you can explain for our listeners what exactly your department's role was and what your role is in that rulemaking process.

Jessica Wachter:

Sure. So, I was Chief Economist and Director of the Division of Economic and Risk Analysis. So, the SEC has six divisions, exams, enforcement, corporation finance, trading and markets. Your listeners may be most familiar with investment management, and then, also the division of economic and risk analysis. So, I was the head of that division. Also, I was chief economist, so it's a dual role. On the one hand, you're running a division. On the other hand, you are an economic advisor to the chair, and also, to the other four commissioners. So, that part was something that I took very seriously.

As director of DERA, that's the Division of Economic and Risk Analysis, I oversaw writing the economic analysis for the proposals and for the final rules, but also, the group that provides support for enforcement. So, that's an important part of what DERA does. We also have various other roles around structured data. We support exams as well. We're active in the rule filings for self-regulatory organizations. But I would say, the primary role for me was really around rule writing and providing the economic analysis around rule writing.

I'll say that Chair Gensler emphasize from the beginning that economics is going to be important. I was very happy that we had a seat at the table, so to speak, at every stage of the rule writing from pre-proposal, all the way through adoption, the specifics of adoption, implementation, litigation strategy, that kind of thing. We were there for all of it.

Genna Garver:

Speaking of litigation strategy just made me think of what I believe is the most significant rule for our fund clients that was issued under Gensler's time. That's the private fund advisor rules, which we're designed to enhance investor protection through required transparency and restrictions of certain practices, but we're vacated last summer by the Fifth Circuit Court of Appeals. Can you briefly share with us some of your experiences working on those private fund advisor rules?

Jessica Wachter:

So, I'll talk generally about the rule writing process because it actually, rules can be very different, but it's really a very similar process for every rule, be it large or small. It always starts with pre-proposal discussions. Eventually, there's a proposal and the proposal goes out for public comment. Of course, that comment period is open and comments come in through the comment period. They continue to come in even after the comment period closes. I have air

quotes here, because after it closes at that point, there's not a strict requirement to consider the comments, but in practice. The SEC does consider as many comments as they can.

Then, the rule is, adopted as proposed or with changes. In that adoption, there has to be an explanation of, you have to confront the comments in the comment file, because those can all be something that is raised if the rule is challenged. It also, it affects how the rule is then interpreted, frankly. That's obviously the path that we took for private funds, as well as for any other rulemaking. I raised this process point because it drives every decision. So, eventually, when the rule becomes adopted, you need to explain to the American public why you did that. That's what the economic analysis does. So that then goes back to the proposal because you need to preview your reasoning in the proposal.

So, even from the very beginning as people are tossing around ideas, trying to define what the problem is, you have to be thinking, is this something that is sensible from an economic perspective, because ultimately that's what's going to go into that final economic analysis for the rule that's adopted.

Genna Garver:

I'm not sure if you can share with us any of the challenges you had with that rule in particular or any concerns that you had in looking at the economic analysis. I know for our clients, obviously, for the most part, our fund sponsors, they were certainly looking at the increased cost of compliance with those rules. I think even on the investor side, we saw some concerns that possibly those costs would be passed on to them. So, I don't know if there are any specifics from your analysis or experience that you felt passionately about for carrying out the purposes of those rules, that you'd like to share with us.

Jessica Wachter:

So, costs are kind of our bread and butter. I mean, we think about costs and we think about benefits. So, we tried to be as careful as we could. Actually, I think I'm not going to recall the numbers off the top of my head, but it was a costly rule. That's the reality. I also will say that we had a very robust set of comments on the economic analysis. Ultimately, the rule was vacated not on the economic analysis, not on the justification, but on authority, but that was something.

It was a very interesting experience to be working on that rule. I mean, certainly, it was challenging, though, in a way not especially so. I would say, every rule brings its challenges. Our goal is to really reflect the trade-offs in the most accurate way possible. Also, to provide the best advice for the commissioners that we can.

Ben Mittman:

Jessica, it's seemed like under the last administration, the rules were coming out of the SEC, the proposals fast and furious, and some of these releases, the proposals, a few entry pages long, or the final rules. The lawyers like Genna and I would spend the weekend combing through it, looking for the legal analysis, looking for the new legal rules and rules of the road, but it's always interesting to come over sort of that portion of the releases that deal with not just the

cost, but the burden hours or the compliance requirements under the paperwork reduction act, and sort of how your team comes up with those numbers.

It's sort of a mystery to us lawyers when we see those hours or dollar amounts and try to figure out how the SEC is balancing those against, say, the need to foster innovation or competition in the U.S. markets. Maybe you can give us a little bit of insight on that.

Jessica Wachter:

Yes. First of all, the Paperwork Reduction Act is mandated, so it's a little bit counterintuitive, because that's actually a mandated section of the releases. The economic analysis is in a little bit of a different category, and it's a separate section. That said, the two sections, they're both part of the releases. It's all the same, Securities Exchange Commission, so there needs to be a basic consistency.

The economic analysis and the Paperwork Reduction Act section straw on each other and how exactly that process works, it depends – that's very specific to the rule writing. I will say this in terms of the numbers. Those numbers are all part of the cost calculation. Generally, the direct compliance cost, which is a superset of the paperwork cost in the PRA section is itself a subset of the general economic costs. So, when you're writing an economic analysis, you'll consider the PRA costs, which by the way, PRA has its own methodology, which might, for whatever reason, overstate that particular section, then, you'll integrate them with other economic costs. All of this, however, goes out to public comment. So, I would encourage anybody looking at those to – if you've got questions to say, "Wait, these numbers seem a little strange to me. I think the number should be X," because that is the purpose of the public comment period.

We were always grateful for the comments that we received, so I think that that's a real strength of the system we have in the United States, is the fact that the SEC can't be arbitrary and capricious and what that means in practice, is they need to justify based on costs and benefits. Again, this needs to go out for public comment and respond to commenters. So, those numbers may seem mysterious. The wages, the hours, all those things may seem mysterious, but in some sense, the purpose of the public comment period is to work through those issues.

Genna Garver:

Actually, I really do appreciate that. It's something that I do focus on particularly when, for example, if I'm chairing a comment letter committee as I've done it a few times for National Society of Compliance Professionals. The focus of those letters really is on the burden to the compliance professionals and the feasibility of that given their resources, and the concerns, perhaps for some of the smaller firms to be able to meet those compliance burdens, and not end up with a period of consolidation in the industry, or higher barriers to entry for some of those startup firms or newcomers to the market. So, there's so much great information in there.

Yes, it certainly can be a mystery as to where those numbers come from when I'm looking at them, but I do think that there's so much great detail in there. For those who are interested in participating in the comment period, certainly encourage them to do so, and to also look at those numbers, because they really can be persuasive when making arguments one way or another in comment letters.

So, maybe we can switch gears and talk about some of the more timely developments as we're seeing with the new Trump administration, we're entering, not surprisingly, this period of deregulation. We recently saw FinCEN announced its intentions of delaying the final RIA AML Rule, and was finalized just last year after many attempts at rulemaking. I thought we finally had it. And then, we just recently saw at FinCEN announcement, and they might even be revisiting the scope. The SECs withdrawn a whole bunch of proposed rules, including rules relating to predictive data analytics, enhanced ESG disclosures, paucity, which was a huge one. I think somebody worked 12 years on that rule and outsourcing by investment advisors. They also extended the compliance date for the foreign PF amendments. But with your economist hat on, what do you think the impact of these deregulation efforts will have on U.S. markets?

Jessica Wachter:

So, I agree, the deregulatory winds are clearly blowing. But in terms of that set of issues, I believe it's important to divide it into a few different buckets. So, in terms of the proposals, I'm not sure anybody was surprised at the withdrawal of those proposals. They were only proposals, which is not to say that they did require a great deal of work. But, since they were only proposals, there's technically no change in the regulatory environment with them being withdrawn. So, it's really just a signal that those particular matters are not under active consideration right now. No need to write those comment letters, pay attention to something else.

Now, in terms of the compliance dates, that's a change. Especially if it's coupled with a statement that says, we're going to reconsider the rule. I mean, that's pretty dramatic because, in the case of the FinCEN rule or in the case of form PF, those rules were adopted rules. So, if the rules themselves are reconsidered now – actually, even with the compliance date, I believe there needs to be an analysis about that change. But you could say that in the long run, assuming the rule is implemented, that's not that big of a change because you just lose those, say, six months or two years. That's a little longer, but maybe it's not a big change.

However, if the rule does change, then that could have an impact. I will only say that that needs to go through the same notice and comment period. So, there'll be a lot of time for seeing what that looks like. So, so far, I wouldn't say that the changes are large, but it's only been a short amount of time since Chair Atkins has been there. So, I'm going to assume that more is coming. I would say that probably the next 18 months is really going to be the crucial period, because after a certain point, it becomes pretty hard to get something proposed and adopted.

In terms of form PF, what I would say is if there are real issues with form PF, that might be a time to start thinking about how it could be improved in a deregulatory direction. But a number of the changes were to make it more efficient for everybody. That's something that I think everybody has an interest in pursuing.

Genna Garver:

Thanks for making that distinction, particularly on the rules that were withdrawn as opposed to delayed. I do remember before Gensler left, we had already heard that those rules would likely be pulled back and slated for re-proposal. Now, we're seeing like a complete withdrawal. So, I

don't think anyone's waiting for the re-proposed version of those rules. Then on, the FinCEN rules, kind of funny, that's been re-proposed many times.

I was pretty careful to double check this FinCEN, announced its intentions of delaying and possibly revisiting the scope, but I don't know that we actually have the official notice for that for the Federal Reserve.

Jessica Wachter:

That's a really good point. That's an important distinction.

Genna Garver:

To your point, that we'll have to wait and see exactly what they mean by all of that. I think that's going to come out in a more formal process, I would suspect. Again, I'm trying not to laugh, because if that will get re-proposed again, I mean, I think we're going for a record. I mean, I feel like it's just been kicking around my whole career, which is saying a lot these days. I'm not a spring chicken. So, I think it'll be the fifth time maybe, I'm losing track. So, we'll have to see about that.

Ben Mittman:

Jessica, talking about the next 12 to 18 months, what do you see as sort of the current priorities of the SEC and how maybe our clients should start thinking about that or adapting to align with those priorities? Do you expect to see, for instance, concrete steps towards the so-called democratization of private funds, making them more acceptable to the retail market. There's a lot of talk about an imminent executive order being issued by President Trump, directing the SEC and the Department of Labor to pave the way for making those alternative assets a viable option in employers' 401(k) plans. We would just love to get your perspective on how you see things going.

Jessica Wachter:

I think that there's an expressed focus on capital formation, and ultimately, on economic growth that can be supported by capital formation. You could imagine that making private funds more accessible is perhaps seen as low-hanging fruit. I think that there might be some concerns there, but I can see, I can imagine that argument being made. So, the point is, if you're trying to get the capital from the investors to the issuers, the private fund industry has just been incredibly important and successful in doing that. So, to have more people be able to access that, I can see the temptation and I'm choosing my words carefully, because clearly, there's costs and benefits here.

The 33 Act was there for a reason. It's been in place for a long time. As we kind of steadily eroded as I believe we've done over the past, nearly a century, I think that there may start to be some problems. There have been over the years problems. So, a lot of the argument that comes in against further regulation of advisors to private funds and to private funds themselves comes from the idea that these are only available to sophisticated investors. Should the scope

be expanded, which it might be under the view of capital formation. There will be implicit or maybe not implicit, an additional set of responsibilities.

That's, I think, something in a long run to watch out for and a potential concern. I mean, I'll also say that ultimately, reputation is perhaps the most powerful form of regulation. So, I think that having a good reputation is probably, you know, all the more important now than we're anticipating a deregulatory environment. I say anticipating, because we don't know what's going to happen.

Genna Garver:

I do think that, obviously, this is cyclical. If you look back throughout history, the pendulum could easily swing the other way. I think our clients are pretty smart about that as well. I don't know that fund managers are necessarily running their business to the whim of the current administration as administrations change from time to time. But their business as having a culture for compliance and operating to best practices. I think that's required by sophisticated investors, particularly allocators like pension plans, regardless of who is sitting in the chair.

I know we're also reminding clients that SEC exams are viewed in hindsight, and sometimes, the exam period can reach back two years plus from the time of the exam. So, even if the current administration takes a view on a certain practice. Of course, we're not talking about a specific rule, but perhaps, like a gray area or some general anti-fraud principle. That's not to say that the next administration will have the same view. We've seen that, in fact, with the marketing rule, we had complete reversal on an FAQ that was issued under the Gensler rule, which was interesting, because the marketing rule was actually issued prior to Gensler's arrival. And he came on board at the time when we were implementing and subject to exam on that rule.

Now, the new administration is taking a different view on certain aspects of that rule regarding the presentation of performance figures for example. So, we're just reminding clients that it's about maintaining that culture of compliance and meeting your fiduciary duties regardless of whomever might be sitting in the chair, and to, obviously, not look at the deregulation, the winds of deregulation, Jessica, as you say, as a ticket to go forth and ignore the obvious responsibilities.

Ben Mittman:

This has been a great discussion. I want to be respectful of your time. I really appreciate you, Jessica, joining Genna and I today, and giving our audience some of your insights. Thank you to our audience for listening today. Please keep your eyes open for future episodes of *PE Pathways*, where we bring experienced deal makers and thought leaders on to the podcast, and share their insight on current private equity and M&A trends and developments. You can find the latest episodes wherever you get your podcast.

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