A Walk-Through Perilous Pitfalls: An Analysis of the SEC's New Private Funds Rule

*By James A. Deeken**

After 17 months of consideration, the Securities and Exchange Commission (the "SEC") adopted a number of new rules governing the relationships between private investment funds and their investors (collectively, the "Private Funds Rule")[1] under the Investment Advisers Act of 1940[2] (the "Advisers Act").

Background, Themes and Reach

The rules reflect an evolution of the SEC's thinking away from a traditional approach that focused on disclosure to one that focuses increasingly on merit. In the latter case, certain practices are disallowed even if they otherwise would be clearly disclosed to prospective investors.

The Private Funds Rule continues an expansion of the SEC's approach in attempting to protect the underlying investors in private investment funds. Under *Goldstein v. SEC*,[3] the actual investors in the funds are not a fund manager's "clients," but rather investors in a fund manager's clients[4], *i.e.,* under the Advisers Act, a private fund manager's clients are the actual funds themselves that it manages, not the investors in those funds. Some commentors objected to the rules during the comment period on the grounds that they arguably ran against the *Goldstein* decision.[5] The SEC however argued that Section 211(h) of the Advisers Act explicitly allows the SEC to adopt rules to protect "investors," which it interpreted to mean and include investors in private funds and not just investors who have a direct client relationship with an investment adviser.[6]

In summary, the Private Funds Rule represents a continued shift under the Advisers Act away from a disclosure based regulatory regime to more of a merit focused regulatory regime[7] and reflects an enhanced approach to treating private investment funds as regulated vehicles themselves even if they are outside the strictures of the Investment Company Act of 1940,[8] the traditional statute for primarily regulating investment funds,

---

*James A. Deeken is a law partner at Akin Gump Strauss Hauer & Feld LLP and an adjunct lecturer at SMU's Dedman School of Law.

with a view towards the treatment of fund investors in private funds as a class in need of protection under the Advisers Act itself.

The other general theme is that the Private Funds Rule represents an effort by the SEC to expand its regulations of private fund investment advisers that are exempt from registration as investment advisers with the SEC. Under the Advisers Act's complicated regulatory scheme there are generally three types of investment advisers: (i) registered investments advisers that are registered as such with the SEC and who have been the traditional focus of regulatory growth under the Adviser Act; (ii) exempt reporting advisers who are exempt from SEC registration pursuant to certain exemptions adopted in the Dodd-Frank Wall Street Reform and Consumer Protection Act Reform Act[9] ("Dodd Frank") but who are required to make regular reports with the SEC on Form ADV;[10] and (iii) advisers who are exempt from registration with the SEC pursuant to an exemption that does not require regular reporting on Form ADV.[11] For purposes of this article, where regulations are referenced as applying to registered investment advisers, they will also be deemed to include investment advisers who are required to be registerd, as an investment adviser cannot avoid the regulations that apply to registered investment advisers by failing to register if otherwise required to do so.

The Private Funds Rule greatly expands the regulations that not only registered investment advisers are subject to but also that investment advisers exempt from registration (either as exempt reporting advisers or otherwise) are subject to, as a number of the components of the Private Fund Rules apply to unregistered investment advisers in addition to registered investment advisers. The Private Funds Rule represents a dramatic expansion of regulation to unregistered investment advisers who may not otherwise be used to vast Advisers Act compliance burdens.

Current Status of the Rule

Except for a component of the Private Funds Rule requiring documentation of annual compliance reviews, the compliance dates for most of the rule provisions are staged in over a compliance effectiveness period ranging from September 13, 2024 until March 13, 2025.

A pending action, *National Association of Private Fund Managers et. al. v. the SEC*,[12] that challenges the Private Funds Rule was filed in the United States Court of Appeals for the Fifth Circuit and seems to rest on the following arguments: the rules (i) exceed the SEC's statutory authority, (ii) were adopted without compliance with notice-and-comment requirements, (iii) are otherwise arbitrary and capricious and (iv) were adopted in violation of the SEC's obligation to consider the rules' effects on efficiency, competition and capital formation. The Fifth Circuit granted a request to give the case expedited treatment.[13]

Much of the new rule relies upon the SEC's authority under Section 211(h) of the Investment Advisers Act (in addition to Section 206(4)). Section 211(h) was adopted as part of Dodd Frank and reads as follows:

> The Commission shall (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and (2) 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.[14]

Arguments may center on whether the new rule is within the scope of such authority. Petitioners argue that Section 211(h) is focused on retail investors and not private funds, as much of the text in surrounding sections of the Dodd Frank focus on "retail investors."[15] Arguments might also focus on whether Section 211(h) is an impermissible delegation of authority to a government regulatory agency under current Supreme Court precedent.

The notice and consent argument may focus on whether the SEC was required to solicit public comment on the final form of a number of the rule's provisions.

The last two arguments may be related. In *The Business Roundtable v. SEC*,[16] the United States Court of Appeals for the District of Columbia Circuit held that the SEC failed to adequately assess the economic effects of a proxy voting rule by, among other reasons, opportunistically framing the costs and benefits and failing to adequately quantify certain costs or explain why they could not be quantified and thus acted in arbitrary manner.[17]

Even if overturned by court action, the Private Funds Rule highlights the SEC's reasoning on a number of conflicts of interest and those interpretations will likely remain in force to some degree even if the rule is overturned.

Analysis of the Components of the Private Funds Rule

This article will not try to repeat, or fully summarize, each rule.[18] There are a number of secondary sources published by law firms that do that. Rather, this analysis will go through and point out some of the nuances and potential unintended consequences of the rules[19] and then concludes by looking at the degree to which the SEC actually had the authority to promulgate the rules.[20]

The "Private Funds Rule" is actually several different rules that are in many cases independent of each other.[21] Below is a break-down of the components and separate rules.

Annual Review Documentation

This is one of the more innocuous rules. It requires that registered investment advisers retain records of the annual review that they are already required to conduct under Rule 206(4)-7[22] by adding a new section to give effect to this. This is a minimal burden and likely is something that most registered advisers do anyway. Accordingly, it has a short compliance date with the rule going into effect November 13, 2023.[23] Since Rule 206(4)-7 only applies to registered investment advisers (or those required to be registered),[24] it has no application to private fund managers who are not registered investment advisers.

Private Fund Audits

New Rule 206(4)-10 (the "Audit Rule") requires registered investment advisers to obtain an annual audit for private funds[25] (as more specifically set forth in Rule 206(4)-10), with exceptions for "securitized asset funds." This is not necessarily a sea change as most private fund managers who are registered investment advisers attain an annual audit anyway to comply with the SEC's pre-existing custody rule embodied in Rule 206(4)-2[26] (the "Custody Rule").

For managers who do not control a private fund (for example, sub-advisers), they must take "all reasonable steps" to cause such an audit. Sub-advisers may need to update their advisory agreements to require the controlling fund manager to undertake an audit that complies with the Audit Rule, in addition to taking other reasonable steps, which the SEC said in the adopting release, depends on facts and circumstances.[27]

Other to introduce a bit of uncertainty for sub-advisers, the Audit Rule is of minimal effect to existing practices, at least for those that use an annual audit to comply with the Custody Rule. However, it does have the import of adding another rule that leads private funds managers to have the funds that they manage audited. That might seem minor. However, the costs of audits have gone up dramatically over the past few years, especially for auditors who are members of the Public Company Accounting Oversight Board and subject to inspection by the Board, which are the auditors required to be used by the Audit Rule, tracking the Custody Rule requirements.[28] To illustrate the issue, assume that a manager has a $5 million fund—a figure that is not necessarily atypical for an emerging manager raising a vehicle for a specific transaction. Assume the annual audit costs are $50,000 and the investment is held for 10 years (not an atypical holding period for a private investment). In that case, the audit cost would be $500,000 over the life of the vehicle (even assuming no further appreciation in audit fees) and the costs of complying with this rule and the Custody Rule would represent a cost equal to 10% of the fund's capital that it invested in an underlying investment. Registered investment advisers may continue to find themselves in a vise when raising smaller fund vehicles.

Quarterly Private Fund Statements

Rule 211(h)(1)-2 contains a requirement for registered investment advisers to provide investors in private funds[29] that they manage with quarterly statements with detailed information set forth in the "Quarterly Statement Rule."[30] There are a number of uncertainties: (i) how to address whether a fund is liquid or illiquid for purposes of reporting when it is a hybrid; (ii) determining in each case whether the reporting materials also constitute advertising materials for purposes of Rule 206(4)-1;[31] (iii) and several other issues.

One item of concern though is that the SEC might bring enforcement actions for even unintentional mistakes in this reporting. The SEC is bringing enforcement actions under Section 206(2) of the Advisers Act,[32] for even mistakes that are the result of mere negligence, and corresponding actions under Rule 206(4)-7[33] for failure to maintain policies and procedures to prevent violations of the Advisers Act.[34] All of this heightens the need for managers to double check reports prepared by third parties that are later distributed to investors and to possibly have policies and procedures in place to address that.

Independent of the Quarterly Reporting Rule, most private fund managers provide some quarterly reporting to limited partners, although the Quarterly Reporting Rule goes into detail beyond what fund managers usually provide to investors generally. In many cases, institutional limited partners have negotiated for and attained reporting that goes beyond the standard quarterly reporting that private fund managers typically provide to all limited partners generally. For example, a number of large institutional investors require that fund managers provide quarterly reporting in the form promulgated by the Institutional Limited Partners Association ("ILPA"). It remains to be seen whether fund managers will be able to get investors to coalesce around one standard form of reporting that meets the requirements the Quarterly Reports Rule. Otherwise, fund managers may need to produce one costly set for reports for all investors that comply with the Quarterly Reports Rule and yet another set for the individual needs and demands of large investors. Given the individualized needs of certain large institutional limited partners, it may be the case that additional specialized reporting for large limited partners will continue to some degree.

The provision of special reporting to certain large limited partners highlighted a separate concern of the SEC that the provision of special or additional information to certain limited partners that is not provided to all investors generally might disadvantage those investors who did not receive it. That concern led the SEC to adopt a second rule regarding the provision of information to investors described below (the "Preferential Information Restriction").

It is interesting to note that the Quarterly State Rule only applies to *registered* investment advisers who manage private funds, but the Preferential Information Rule applies to *all* private fund managers, whether registered or not.

The Preferential Information Rule

Rule 211(h)(2)-3(a)(2) prohibits providing information regarding the portfolio holdings or exposures of a private fund or of a similar pool of assets[35] to any investor if the fund manager reasonably expects that the provision of such information would have a "material, negative effect" on other investors in such fund or similar pool, unless the adviser offers the information to all investors in the private fund and any similar pool of assets at the same or substantially the same time.[36]

The concern underlying the rule seems to be focused on a concern that investors with that special information may use it to do something that would harm the other investors. The most apparent, but non-exclusive, example of that would involve an "open-ended" fund, a fund where investors can generally redeem freely. In such a fund, an investor with special information might be able to see in advance, before other investors, that the portfolio had risks materializing and thus be able to redeem on that special information, potentially allowing that investor to pull its money out before a crisis developed and possibly leaving remaining investors in the fund with remaining assets that might be harder for the fund to dispose of at optimal prices.

There are a few nuances that present themselves in this rule. The first is that it applies not only to investors in the same fund but to any information given to investors in a "similar pool of assets." Similar pool of assets is defined to mean generally a pooled investment vehicle with "substantially similar investment policies, objectives, or strategies to those of" the private fund in question. It is typical for some extremely large investors to have a fund manager form a special fund just for them, often referred to as "funds of one." Thus, fund managers will need to scrutinize any special information rights given to investors in a fund of one and possibly offer the same information all investors in the related private fund. This may create some awkward and ambiguous situations where the information in question specifically relates to the fund of one or is information that the fund of one investor may consider related to its proprietary analysis.

The second nuance is that if a private fund grants special rights, information or otherwise, to investors that could have a material adverse effect on other investors, without disclosure of that to the investors and a specific enumeration of the related risks, that could very well raise concerns under pre-existing anti-fraud provisions of both the Securities Act of 1933 and the Advisers Act, independent of the Preferential Information Rule. The Preferential Information Rule shifts the SEC's regulatory focus from a disclosure-based regime to a merit-based regime. Under the Preferential Information Rule, a manager cannot provide certain prescribed information rights to investors *even if the risk is clearly disclosed to the other investors before they make their investment decision to invest in the fund*. The Preferential Information Rule and a number of the other components of the Private Funds Rule drive an increasing wedge between the non-merit, disclosure-based regime under the Securities Act of 1933 and the approach taken under the Advisers Act.

"Side Letter" Disclosure Rule

Special information rights are not the only types of rights that fund managers grant to investors. At times, investors will negotiate "side letters" that effectively modify the provisions of the fund documents as applied to them. Rule 211(h)(2)-3 applies to all fund managers (whether registered or not) and reflects a more generic concern on the part of the SEC regarding such side letter practices and requires that:

- Notice be given to prospective investors in advance (before an investor's investment) of specific information regarding preferential treatment related to material economic terms provided by the fund manager or its related persons[37] to other investors in the private fund in question.
- For an illiquid fund,[38] that the fund manager distribute to all investors in the private fund all other preferential treatment that the fund manager or its related persons has provided to other investors as soon as reasonably practicable following the end of the fund's fundraising period.
- For a liquid fund,[39] the disclosure related to other preferen-

tial treatment must be as soon as reasonably practical following the investor's investment in the fund.

- In both cases, the information for any preferential terms must be updated on an annual basis.

As is the case with the Preferential Information Rule, there are number of nuances with this rule. First, the requirement to disclosure preferential treatment is not qualified by any concept of materiality or any concept of any harm to other investors. The import of this is that a fund manager may need to provide voluminous disclosure of seemingly mundane provisions to investors. For example, if a public entity act has special "freedom of information" disclosure rights, in what detail would that need to be disclosed to all investors? Such disclosure may raise confidential concerns on the parts on the investors who receive such provisions, although it might be possible for fund managers to redact or, possibly pending further guidance and other developments, be general in disclosure. However, it could result in a heavy weight of disclosure for all investors to wade through. The absence of qualification for materiality or items that harm other investors is questionable. For example, if there is a special term that is material, it might be surrounded by numerous unimportant items and thus be less likely to be noticed.

The impact on market practice is unknown at this point, in terms of whether it will result in all investors receiving a summary compendium of side letter terms or something more narrowly tailored—or even something more voluminous. In addition, it is unclear whether the disclosure in advance of material economic terms will tighten the willingness of fund managers to give discounts on management fees or carried interest, for example, for fear that other or smaller investors may try to piggyback on those when they see them. Conversely, it is unclear whether the fund managers will expand the discounts once they are disclosed. The second scenario may be unlikely in that it may be easy for managers to articulate a rationale for "volume" discounts. In fact, it is not uncommon for fund managers in many funds to disclose different management fee rates based on the size of an investor's commitment. However, to the extent that fund managers become more reluctant to grants discounts to large investors, this ironically could have the impact of potentially harming large pension or similar investors despite the rule's stated focus on helping investors.

Similar to the Preferential Information Rule or the Special Redemption Rule, discussed below, the "Side Letter" Disclosure Rule applies for investors in the same private fund and in similar accounts. Thus, it could in a number of cases apply to terms granted to an investor in a corresponding fund of one.

There is one other wrinkle with the "Side Letter" Disclosure Rule that is worth noting. As described in the first bullet above, the notice of side letter terms must be given to prospective investors in advance of their investment in a private fund if it relates to material economic terms. It is interesting to note that the rule does not define "material economic terms." To a lay person's reading that would seem to mean items such as management fees, expense provisions or performance allocation provisions. However, the text in the adopting release indicates that the scope could be broader.

> To address commenter concerns about timing and impeding the closing process, the final rule will limit advance disclosure to those terms that a prospective investor would find most important and that would significantly impact its bargaining position (i.e., material economic terms, including, but not limited to, the costs of investing, liquidity rights, fee breaks and co-investments).[40]

Then further detail is added in footnote 882 to the above text, which reads in part as follows:

> Co-investment rights will generally qualify as a material, economic term to the extent they include materially different fee and expense terms from those of the main fund (e.g., no fees or no obligation to bear broken deal expenses).[41]

That portion is helpful as it seems to clarify that a co-investment right would only be a material economic term if it had fee or expense provisions associated with it. However, the remaining portion of the footnote reads as if it were written by a different author on the SEC staff who wanted to take a more possibly more expansive view and may contradict the preceding part.

> Even if co-investment rights do not include different fee and expense terms, and for example, are offered to provide an investor with additional exposure to a particular investment or investment type, investors often negotiate for those rights and give up other terms in the bargaining process in order to secure access to co-investment opportunities. As a result, co-investment terms generally will be material given their impact on an investor's bargaining position.[42]

It is unclear why the SEC did not set forth a definition of material economic terms, but it may have been due to internal disagreement as how broadly or narrowly to define it.

The Preferential Redemption Rule

Similar to the Preferential Information Rule, Rule 211(h)(2)-3(a)(1) prohibits a fund manager (whether registered or not) from granting preferential redemption rights to an investor in a fund or "similar pool of assets" if the fund manager reasonably expects such rights to have a material, negative effect on investors in the fund or similar pool with certain exceptions for redemption rights required by law set forth in the rule and if all other current and future investors in such fund or similar pool are offered the same redemption rights.

The rule is motivated by the same concerns of the SEC that underly the Preferential Information Rule. Likewise, it raises the same issues with respect to similar pools of assets discussed with the Preferential Information Rule.

It further evidences a shift in the Advisers Act away from a disclosure-based regulatory regime to a merit-based regime. Prior to the Preferential Information Rule, a fund manager, depending on the specific facts and circumstance, might have been able to grant special redemption rights if the rights were fairly disclosed with all attentive risks to the investors being described.

The shift of SEC's thinking from a disclosure focus to a merit focus, may seem good for investors at first glance, at least for those investors without the special redemption rights.

However, beyond an initial glance the impact is that not clear. There is no shortage of examples where a fund manager has received a "seed" or "anchor" investment for an extremely large investor that received special information rights, or for that matter special redemption rights, either in the fund in question or in a "fund of one" similar pool of assets, in exchange for that investment, accompanied by clear and full disclosure for the other investors. The special rights are effectively, in those cases, compensation for the initial large investor to take risk on an unproven emerging manager. Large investors don't need to take that risk and the forbearance on special terms for them could constrict the pool of capital for new managers. The rule could have the impact of imposing a barrier to entry for new managers, which could possibly increase and consolidate power among large managers and thereby reduce the negotiating power of investors of which the SEC expressed concern.

Limits on Regulatory Investigation and Compliance Expenses

Rule 211(h)(2)-1(a)(1) prohibits a fund manager (whether registered or not) charging or allocating to a fund fees or expenses associated with an investigation unless the fund manager receives the consent of a majority in interest of the private fund's investors (with each investor being asked) that are not related persons of the fund manager. However, no fees or expenses may be passed through to the fund if the investigation resulted in a sanction for a violation of the Advisers Act or its related rules.[43]

The rule creates some awkward situations for fund managers. Generally, fund managers receive advance consent for fund expenses as they are disclosed in the fund offering documents. Here the SEC seems to be taking the approach that advance disclosure and related consent will not work.[44] So, in practice, the way it would possibly work would be that a manager would go through an exam and then after the exam or investigation is concluded, it would need to go to the investors and basically say "we just went through an exam and now we would like you to agree to pay the expenses in connection with it." Such approach is unconventional and seems to be part of a merit based regulatory approach resting on the assumption that advance disclosure, even if it is clear and consented to should not work.

Lastly, the exception where investor consent does not work if there is a sanction under the Advisers Act potentially creates an incentive for a fund manager to settle charges with the SEC under another securities statute, such as the Securities Act of 1933 or the Securities Exchange Act of 1934, rather than the Advisers Act.

Rule 211(h)(2)-1(a)(2) prohibits a fund manager (whether registered or not) from passing through compliance, regulatory or exam fees or expenses unless the fund manager distributes to investors notice of such fees or expenses, including the dollar amounts, to investors within 45 days of the end of fiscal quarter in which they were incurred. The import will be to separately track expenses to enable the reporting. Another facet that the industry will wrestle with is what constitutes "a regulatory or compliance" expense that is separate from general legal expenses.

These rules seem to reflect a mix of a merit-based and a disclosure-based regulatory regime. It seems to take the approach that generic advance disclosure will not work in some cases as set forth above, even if consented to by other investors, but that current detailed disclosure may work in some circumstances.

Other Prohibited Practices

Under Rule 211(h)(2)-1(a)(4) fund managers (whether registered or not) are not allowed to charge or allocate in a non-pro rata basis expenses related to a portfolio investment (or potential investment) to one fund when multiple funds or clients advised by the fund manager or its related person invest, or propose to invest, in the same underlying portfolio company. There is an exception if the non-pro rata charge is fair and equitable under the circumstances and disclosed to investors in advance with a description of how it is fair and equitable under the circumstances.

Because "fair and equitable" is inherently subjective, its use might be fairly limited in how fund managers use it and may be constrained to limited circumstances or avoided all together.

However, if there are legitimate circumstances where additional expenses were incurred by one fund due to is unique status, literal compliance with the rule with may lead to some situations that ironically might not be ironically not fair and equitable. For example, if a fund manager manages three funds and one of them has non-US investors and as a result incurs expenses solely or primarily due to having non-US investors, if it wanted to literally comply with the rule, without taking risk on the exception, it would apply them pro rata, but would that pose other risks for the fund manager? Does the rule potentially put managers between a rock and a hard place?

Rule 211(h)(2)-1(a)(5) prohibits a fund manager (whether registered or not) from borrowing or receiving an extension of credit or loan of money, securities or other assets from a private fund client unless a majority in interest of fund investors (with each investor being asked) who are not related persons of the fund manager consent after receiving detailed disclosure meeting requirements set forth in the rule. This practice is not necessarily common so the practical application of this rule may be limited.[45]

Rule 211(h)(2)-1(a)(3) prohibits a fund manager (whether registered or not) from reducing a clawback by the amount of any tax-related items unless the fund manager provides written notice to the investors that sets forth the amount before and after reduction within 45 days of after the end of the fiscal quarter in which the clawback occurred. The final rule is a push back from the initial proposed rule that would have prohibited tax-related deductions in their entirety and reflects one area where the SEC leaned more to a disclosure-based regulatory approach.

Adviser-led Secondaries

Rule 211(h)(2)-2 imposes certain requirements on fund managers (whether registered or not) in connection with "adviser-led secondary transactions," which are transactions where the fund manager or any its related persons offer investors a choice between selling all or a portion of their interest in a fund or converting or exchanging all or a portion of their interests for interests in another fund managed by the fund manager or its related persons.

In such a context, the fund manager is required to distribute a fairness opinion or valuation opinion from an independent third party, along with a disclosure of a summary of any material business relationships that the fund manager or its related persons has had with the opinion provider during the prior two years.

Rejecting a disclosure-based approach, a fund manager could not satisfy the requirement by disclosing as a risk that there is no fairness opinion. The SEC instead seems to be taking the position that any such transaction without a fairness opinion is inherently meritless or at least posing merit-based risks, even if disclosed.

The certainty of the rule is increased costs as opinion providers charge both for their work and for the risk that they take in rendering opinions. Whether there is investor demand for such opinions is unclear. Adviser-led secondaries occur frequently and even large investors do not always demand fairness opinions, which highlights a question as to the degree to which the market values them.

A Key Provision That Was Not Adopted . . . Or At Least Not Directly Adopted

The Proposed Rule Release proposed that the prohibited practices that would apply to private fund managers include a prohibition on seeking "reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful malfeasance, bad faith, negligence, or recklessness in providing services to the private fund"[46] (the "Negligence Rule").

This proposed rule would have rattled the funds industry as private fund documents almost always provide that a private fund manager is not liable for its mere negligence, but typically only liable for bad faith, willful misconduct, gross negligence and items of similar magnitude, and correspondingly provide that a private fund manager is entitled from indemnity from the private fund except for items of equal gravity. The adoption of the rule would have required fund managers in their fund documents to change the exclusions for their exclusion of liability provisions and indemnification provisions from a gross negligence standard to a mere negligence standard. The difference "gross negligence" and "negligence" may seem academic in nature. However, although it varies venue to venue, "gross negligence is generally associated with conduct, among other things, approaching recklessness[47] or other bad behavior whereas negligence is generally associated with a breach of a duty of care. The import of going to a negligence is untested, but one fear is that it would lead to "strike" lawsuits if a fund has bad performance.

When the Facts Sheet: Private Funds Adviser Reforms: Final Rules[48] was released during the SEC's open meeting on August 23, 2023 the initial reaction of many was a sigh of relief as it appeared that the SEC had dropped the requirement. However, the nuance is in the detail. Instead of adopting the Negligence Rule, the SEC took the position that it was not necessary to adopt the Negligence Rule because in its view it was, in least in part, the law anyway, or in its own words:

> After considering comments, we are not adopting this prohibition, in part, because we believe that it is not needed to address this problematic practice . . . We have taken the position that an adviser violates the antifraud provisions of the Advisers Act, for example, when (i) there is a contract provision waiving any and all of the adviser's fiduciary duties or (ii) there is a contract provision explicitly or generally waiving the adviser's Federal fiduciary duty, and in each case there is no language clarifying that is the adviser is not waiving its Federal fiduciary duty or that the client retains certain non-waivable rights (also known as a "saving clause"). A breach of the Federal fiduciary duty may involve conduct that is intentional, reckless or *negligent*. Finally, we believe that an adviser may not seek reimbursement, indemnification, or exculpation for breaching its Federal fiduciary duty because such reimbursement, indemnification, or exculpation would operate effectively as a waiver, which would be invalid under the [Advisers] Act.[49] (emphasis added)

In support of its position that negligence can constitute a breach of a private fund manager's Federal fiduciary duty, the SEC cites a footnote in its 2019 IA Fiduciary Duty Interpretation stating that claims under Section 206(2) of the Advisers Act are not scienter based and "can be adequately plead with only a showing of negligence."[50] Section 206(2) of the Advisers Act provides that it is unlawful for an investment adviser "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client". It is unclear whether the SEC is trying to take negligence in a fraud-based context and trying to apply it in other contexts.

To add the confusion, the SEC closes its analysis of the Negligence Rule with this passage:

> We continue to not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable State law. However, to the extent that a waiver clause is unclear as to whether it applies to the Federal fiduciary duty, State fiduciary duties, or both, we will interpret the clause as waiving the Federal fiduciary duty.[51]

Note the Adopting Release is broader in application than the 2019 Fiduciary Duty Interpretation which seems to more focused on retail investors:

> This Final Interpretation makes clear that an adviser's federal fiduciary duty may not be waived, though its application may be shaped by agreement. This Final Interpretation does not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law . . . The question of whether a hedge clause violates the Advisers Act's antifraud provisions depends on all of the surrounding facts and circumstances, including the particular circumstances of the client (e.g., sophistication). In our view, however, there are few (if any) circum-

> stances in which a hedge clause in an agreement with a retail client would be consistent with those antifraud provisions, where the hedge clause purports to relieve the adviser from liability for conduct as to which the client has a non-waivable cause of action against the adviser provided by state or federal law. Such a hedge clause generally is likely to mislead those retail clients into not exercising their legal rights, in violation of the antifraud provisions, even where the agreement otherwise specifies that the client may continue to retain its non-waivable rights. Whether a hedge clause in an agreement with an institutional client would violate the Advisers Act's antifraud provisions will be determined based on the particular facts and circumstances. To the extent that a hedge clause creates a conflict of interest between an adviser and its client, the adviser must address the conflict as required by its duty of loyalty.[52]

The SEC noted that most commenters opposed the adoption of the Negligence Rule, by arguing that it would impose higher costs for investors, increase the threat of private litigation and cause investors to take less risk.[53]

The SEC's dropping of the Negligence Rule is curious. Its stated reason seems to be that the adoption of the rule is unnecessary as the proposed Negligence Rule already reflected the law anyway. There are issues with this position as the negligence standard used in the 2019 IA Fiduciary Duty Interpretation seemed mainly focused within the bounds of Section 206(2) of the Advisers Act and the "hedge clause" issues seemed more focused on retail investors, whereas the Negligence Rule would have applied these standards more globally.

If the SEC thought that the proposed Negligence Rule already reflected current law, why did it propose it to begin with? The proposed rule was released in March, 2022. There was no intervening changing in applicable law during that time. The main source of law that it cites is the 2019 IA Fiduciary Duty Interpretation. Federal government regulatory agencies generally don't propose rules that prohibit conduct that they think is already in violation of law, only to pull back the proposed rule from final adoption on the grounds the conduct is arguably prohibited by the applicable law. It is possible that the SEC feared adopting the Negligence Rule would be subject to a potential successful court challenge and thus, it might have instead decided to "make law" informally through informal discussion in the Adopting Release that may be outside of the scope of court challenge.

Authority and Challenge

The SEC is largely resting its authority to promulgate the Private Funds Rule on Section 206(4) of the Advisers Act and Section 211(h) of the Advisers Act.

Section 206(4) grants the SEC the authority to adopt rules "reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive or manipulative." The SEC reads this statutory authority as giving it the ability to adopt "prophylactic" rules against conduct that is not necessarily fraudulent.[54] As part of its reasoning for this position it cites *United States v. O'Hagan*,[55] which provided under Section 14(e) of the Securities Exchange Act that the SEC had the power to issue rules to prohibit acts that are "not themselves fraudulent . . . if the prohibition is 'reasonably designed to prevent . . . acts and practices that [that] are fraudulent."

The expansive of view of the SEC's rule marking authority under 206(4) may be necessary if 206(4) is supposed to be the authority for the Private Funds Rule. As noted, the Private Funds Rule moves in many respects in a direction away from being primarily a disclosure based regime to more of a merit based regulatory regime. Under a primary disclosure base regime a practice would generally not be considered fraudulent if the practice and risks associated with it were sufficiently disclosed to prospective investors. The SEC seems to be interpreting *O'Hagan* as giving it authority to adopt a wide range of rules on the grounds that they help prevent fraud. Still, however under that approach there arguably would still need to be a nexus with fraud. Without such a nexus, 206(4) would be read as giving the SEC blank check rule making authority. It may be at best be ambiguous whether there is a sufficient fraud nexus for a number of the components in the Private Funds Rule.

The SEC notes that the Private Fund Audit Rule "increases the likelihood that fraudulent activity or problems with valuations are uncovered, thereby deterring advisers from engaging in fraudulent conduct."[56] The SEC also notes that the restricted activities rule and preferential treatment "prevent advisers from engaging in certain activities that could result in fraud and investor harm, unless advisers make appropriate disclosures or obtain consents, as applicable."[57]

The cited basis for the restricted activities and preferential treatment rule in particular raises questions. First, even if someone extrapolates the *O'Hagan* reading of Section 14(e) of the Securities Exchange Act over to Section 206(4) of the Advisers Act is not clear that it would give the SEC authority blanket authority to issue rules to prevent actions that "could result in fraud." "Could result in fraud" could be expansive as virtually any business practice "could" result in fraud and that expansive reading may conflict with the *O'Haga*n reading of the Section 14(e) of the Securities Exchange Act which uses the more narrowly tailored "reasonably designed" criteria for SEC rule-making authority. The SEC seems to waffle a bit on the fraud nexus, adding "investor harm" to their argument.[58]

Second, the SEC ends it justification with "make appropriate disclosures or obtain consents, as applicable." In a strictly fraud-based regime, an investor consent requirement would traditionally be irrelevant and beyond the scope of preventing fraud. Rather, as long as something is fully and clearly disclosed, then the disclosure itself would traditionally cure any fraud problem. Consent addresses primary a "governance" issue with a fund rather than a "fraud" issue. The SEC cites no authority for its supposed position that preventing fraud under Rule 206(4) requires an investor consent governance element, in addition to disclosure.

That may be the reason why the SEC also cites Section 211(h). Section 211(h) provides:

> The Commission shall (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interests, and compensation schemes for brokers, dealer, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.

Read literally, the authority under the statute encompasses a wide range of subjects. Some commentors who objected to the Private Funds Rule argued that it was intended to apply to retail investors.[59] Section 913 of Dodd Frank itself usually uses the reference "retail investors" in the text that surrounds the portion of Dodd Frank that implemented Section 211(h) of the Advisers Act.[60]

The SEC responded to such objections by noting:

> Section 913 of the Dodd-Frank Act contains numerous sub-parts, several of which specifically pertain to "retail customers" . . . in adding Section 211(h) of the Advisers Act entitled "Other Matters," Congress spoke of "investors," and in so doing gave no indication that is referring to "retail customers," a term that it had defined and used in various other sub-parts. The "Other Matters" provision likewise contains no instruction to the Commission to include or exclude private fund investors from the term "investors" . . . This provision makes no mention of "retail" customers, "retail" clients, or "retail" investors, and therefore does not by its plain meaning apply to only *retail* investors.

Skeptics of the SEC's authority may point out that Section 913 of the Dodd-Frank also added Section 211(g) of the Advisers Act which provides:

> (1) In General.—The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized

> investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of this Act when providing personalized investment advice about securities, *except the 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 contract with such adviser*. The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser.[61] (emphasis added)

Section 211(g) of the Advisers Act could be read to mean the focus of Section 913 was on individual investors and not investors in private funds. Two commissioners remained unswayed by the SEC's textualist statutory interpretation of Section 211(h).[62]

However, if someone assumes that the SEC's textualist statutory interpretation is correct, that alone will not end the issue of whether the SEC actually has authority under Section 211(h). Petitioners in *National Association of Private Fund Managers* might argue that the broad blanket and somewhat vague authority handed to the SEC in Section 211(h) (assuming that the SEC is correct in its statutory interpretation) runs afoul of the Major Questions Doctrine. The Supreme Court recently dealt with the doctrine in *West Virginia et al. v. Environmental Protection Agency et al.*[63] where it held that the Clean Air Act did not grant the Environmental Protection Agency the authority to impose emissions caps pursuant to a Clean Power Plan rule that the EPA promulgated.

The Supreme Court's reasoning in *West Virginia* was that Congress intends to make major policy decisions, and not leave those to federal regulatory agencies, explaining that in matters that implicate fundamental policy, there must be clear Congressional authorization for the power that a regulatory agency seeks to exercise.[64] Key to the Court's analysis was that Congress had consistently rejected proposals to amend the Clean Air Act to create the emissions cap program that the EPA was seeking to impose. As the Supreme Court concluded:

> Capping carbon dioxide emissions at a level that will force a

> nationwide transition away from the use of coal to generate electricity may be a sensible "solution to the crise of the day" . . . But it is not plausible that Congress gave EPA the authority to adopt on its own such a regulatory scheme . . . A decision of such magnitude and consequence rests with Congress itself, or an agency acting pursuant to a clear delegation from that representative body.[65]

The case is confined to its own unique facts. However, the Supreme Court highlighted the application of the Major Questions Doctrine by alluding to a few past precedents that serve as illustrative examples of how the doctrine has been applied:

- *MCI Telecommunications Corp. v. American Telephone & Telegraph Co.*,[66] where the Supreme Court rejected an attempt by the Federal Communication Commission to eliminate rate regulation base on a "subtle" provision that allowed the commission to "modify" rates;
- *FDA v. Brown & Williamson Tobacco Corp.*,[67] where the Supreme Court rejected a Food and Drug Administration attempt to regulate cigarettes based on a "cryptic" statutory provision that give the FDA the power to regulate "drugs" and devices;
- *Gonzales v. Oregon*,[68] where the Supreme Court doubted that the Attorney General had the authority to regulate drugs for physician-assisted suicide through "oblique" statutory language; and
- *National Federation of Independent Business v. OSHA*,[69] where the Supreme Court rejected an OHSA attempt to impose a nationwide COVID-19 vaccine mandate based on a statutory provision that was adopted 40 years before the pandemic.

In this case the SEC would likely respond to a major questions argument by claiming that Section 211(h) is a statute on point.[70] So, it may be particularly important to analyze the language of the statute in question. As noted, the first part of Section 211(h) provides as follows:

> The Commission shall (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest;

This part of the statute may not be helpful to the SEC as it governs disclosures to investors regarding the terms of their relationships with their investment advisers. As evidenced by the *Goldstein* decision, investors in a private fund do not have an investment advisory client relationship with "their investment adviser" as the private fund is the investment adviser's client.[71] The SEC's analysis in the Adopting Release of its statutory authority seems to rely more upon the second part of the statute.

(2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interests, and compensation schemes for brokers, dealer, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.

The relevant elements that are enumerated are:

- sales practices;
- conflicts of interests; and
- compensation schemes.

The SEC's analysis on how the elements of the Private Funds Rule fit into any of the three buckets is brief and the SEC addresses the issue in passing in the Adopting Release. It makes the following assertions in attempting to tie the elements of the Private Funds Rule back to the statutory language:

- offering preferential terms to certain private fund investors to attract investment is a "sales practice";[72]
- "conflicts of interest" presents themselves in adviser-led secondaries because the adviser can be on both sides of the transaction;[73]
- an adviser opportunistically valuing a private fund to increase its compensation is a "compensation scheme";[74] in justifying the Audit Rule;
- the restricted activities rule is designed to "prohibit certain activities that involve conflicts of interest and compensation schemes that are contrary to the public interest";[75] and
- the preferential treatment rule addresses a concern that sales practices do not provide investors with sufficient detail with respect to terms offered to other investors.[76]

Any dispute over the scope of the SEC's authority will likely focus on the degree to which there is a sufficient nexus to the applicable statutory language. For example, is banning certain preferential terms a "sales practice" as it that term would be commonly understood? Is requiring disclosure of side letter terms that are not material economic ones after an investment decision related to a sales practice, since at that point an investment decision has already been made? Does even requiring advance disclosure of material economic terms granted to other investors constitute a "sales practice"? On the surface, it might not seem like the preferential terms are being used to sell to the investors who have them and already know about them. The SEC does not offer any authority for its interpretation of "sales practice" and a court may need to add definition to the term for purposes of applying the statute. Finally, does the Quarterly Statement Rule relate to any of a sales practice, a conflict of interest or a compensation scheme?[77]

Secondly, since there is an explicit provision on point in Section 211(g) of the Advisers Act that was also added by Dodd-Frank, there may be a good argument that the "more specific governs the general" and since Section 211(g) has an explicit provision addressing the rulemaking ability of the SEC with respect to investors in private funds that it may trump any alleged vague authorization in Section 211(h) to pass regulations with respect to investors in private funds.

Petitioners allude to another potential challenge to the Private Funds Rule. Section 202(c) of the Advisers Act provides that:

> Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

That may sound like a requirement that the SEC just "check the box" by running through some economic analysis as part of its decision making, in a manner where it could possibly just give "lip service" to the requirement of Section 202(c). Afterall, it merely says the Commission merely needs to consider the items enumerated in Section 202(c).

However, Section 202(c) was given teeth in *Business Roundtable v. SEC*,[78] where the D.C. Circuit held that the SEC failed to adequately assess the economic effects of a proxy voting rule by, among other reasons, opportunistically framing the costs and benefits and failing to adequately quantify certain costs or explain why they could not be quantified and thus acted in arbitrary manner.[79] *Business Roundtable* addressed substantially equivalent provisions in the Securities Exchange Act and the Investment Company Act that also required consideration of a proposed rule's effect on efficiency, competition and capital formation.[80]

Citing *Chamber of Commerce v. SEC*,[81] the court noted that the statutory obligation of the SEC includes a duty to determine "as best it can the economic implications" of a rule and went so far to call the SEC's statutory a "unique obligation."[82] In the words of the court, the SEC had:

> inconsistently and opportunistically framed the costs and benefits of the rule; failed to adequately to quantify the certain costs or to explain the why those costs could not be quantified, neglected to support its predictive judgments, contradicted itself; and failed to respond to substantial concerns raised by commenters.[83]

In particular, the court took issue with how the SEC seemed to rely upon speculation for a key prediction of the economic consequences of the proxy voting rule at issue, by offering no evidence that the relevant predicted behavior is borne out in practice[84] and further noted that the SEC did nothing to estimate and quantify expected costs or claim that estimating those costs was not possible.[85]

The guideposts for the SEC in complying with Section 202(c) seem to be to avoid the following:

- opportunistically framing and costs benefits of a rule;
- failing to adequately quantify certain costs, without explanation of why they could not be quantified;
- neglecting to support predictive judgments or relying upon speculation to support such judgments;
- contradicting itself; and
- failing to respond to commenters.

The "Economic Analysis" in the Adopting Release runs 270 pages and likely was written primarily for the purpose of trying to survive a court challenge under Section 202(c). Towards the beginning of the analysis the SEC assets that a benefit of the Private Funds Rule is that it will make the market between fund managers and investors more competitive.[86] The SEC's analysis in this respect rests upon the premise that investors do not have bargaining power.[87] The SEC insists that there is a "market failure"[88] and investors are effectively forced to take "poor legal terms"[89] and "bad terms"[90] generally.

The evidence that the SEC relies upon for these conclusions is largely based on a survey of members of Institutional Limited Partner Association ("ILPA"), which is a trade group for institutional fund investors,[91] remarks of lawyers representing institutional limited partners[92] and ILPA materials.[93] There is no discussion of an actual study of fund terms. Nor did this analysis rest on surveys of private fund managers or agents that represent them. There is no reference to any survey of, or opinions of placement agents, who often act as intermediaries between fund managers and large limited partners. Although it would have been easy to obtain from its sources on the limited partner side, there is no study of common or market terms in fund documents, nor any analysis of whether such terms, such as management fee rates, performance fee rates and economic terms have grown worse or better for private fund investors over time. Further, there was no study or survey of what the SEC termed "non-price contractual terms."

The SEC's analysis seems to do little to protect it from an allegation that it selectively gathered evidence to support its implicit position that the private fund documents that investors face are little more than contracts of adhesion.

It would not have been particularly difficult for the SEC to test its "market failure" hypothesis. One of the largest growing areas for private funds is private credit, an area where private funds have stepped in to fill the void left by redacted commercial bank lending. In this new, large market, each of management fee terms, performance compensation terms, investment period terms and fund length are generally more restrictive for fund managers and more favorable for investors than those found in typical "private equity" or "venture capital" funds. If there is really a "market failure" why is a new market growing rapidly with terms that are more favorable for investors?

Further, the SEC's reasoning that investors accepting "poor legal terms" and "bad terms" is evidence of market failure raises that risk that it might be seen as having acted opportunistically.

What is "bad" is both subjective and relative. It is relative in the sense that something that is "bad" for one party is often "good" for a counterparty. There could always be a provision for an investor that is better. For example, if a private fund pays a management fee of 1.5% is that "bad"? 0% would be better but would that give a fund manager an incentive to manage the fund or be enough to attract the right talent? To use an overly simple example, if a private fund and a limited partner negotiate over a management fee where the private fund manager initially wants 1.75% and the investor wants 1.25% and they compromise on 1.50% does that mean that the investor got stuck with bad terms because it didn't get 1.25%? Does the SEC mean to suggest that any time that investors don't get what they ask for, that the terms are then "bad"? The SEC's analysis tends to ignore the realities of negotiation where neither side seldom gets exactly what it wants. Such a result is not "bad"; it allows people to reach a middle ground and commerce to be conducted on mutually agreeable terms.

The SEC analysis of the costs of imposed on private fund managers may leave it open to attack. It does little to gauge how fund managers will address the increased costs of regulation. It engages in no analysis in how smaller fund managers will be able to manage the costs and does not seem to consider whether the new regulations will effectively act as "barrier to entry" for new, potential emerging managers. The SEC does not consider the risk that any barriers to entry may entrench current large managers, drive some managers out of business and deter potential entrants. Any of these effects would ironically have the effect of worsening competition in the private funds market. The SEC does no study regarding whether the management fees that private funds managers are "profit centers" or whether they typically just cover costs and does not consider whether the answer may be different and more onerous for smaller managers who do not have scale in comparison to larger more established managers.

When it addresses the increased costs for private fund managers, the SEC engages in this dialogue, which some might view as flippant:

> Moreover, the final rules . . . does not deprive fund advisers of compensation for their services: Insofar as the rules shift costs and risks back onto fund advisers, the rules strengthen the incentives of advisers to manage risk in the interest of fund investors and, in doing so, does not preclude fund advisers from responding by raising prices of services that are not prohibited and are transparently disclosed and, in some cases, where investor consent is obtained.[94]

Should this passage to be read to mean that if a private fund manager charges a 2.0% management fee and its costs are estimated to equal an additional seven basis points that it could raise its management fees to awkward 2.07%? If, in fact, the increased costs are passed onto investors could that in fact worsen the picture for investors and possibly undermine efficiency? The SEC seems to contradict its earlier statement that managers could pass along expenses to investors, in two subsequent places suggesting that it in fact might not be that easy for private fund managers to pass along the additional costs.[95]

As noted earlier, the restrictions on preferential treatment, even if disclosed, could have an impact on the ability of emerging manager to gain "seed capital" as seed capital providers often seek preferential, yet disclosed, terms. The SEC's study contains no analysis on the risk that capital for new managers might be impaired and no analysis on how this may impact the competitiveness of the private funds market.

Conclusion

Regardless of how the Private Funds Rule fairs, it signals a new view on the part of the SEC to try to move beyond a disclosure-based regulatory regime under the Advisers Act and portends an expansion of regulation to a larger group of investment advisers. Such an approach may be borne out in how the SEC approaches enforcement actions, independent of whether the rule withstands judicial scrutiny.

NOTES:

[1]Private Fund Advisers; Documentation of Register Investment Adviser Compliance Reviews, Investment Advisers Act Release No. 6383 (Aug. 23, 2023) [88 FR 63206 (Sept. 14, 2023)] (the "Adopting Release").

[2]15 U.S.C.A. §§ 80b-1 to 80b-22.

[3]*Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (case invalidating a prior rule promulgated by the SEC under the Advisers Act that purported to treat investors in a private fund advised by an investment adviser as clients of the

investment adviser, rather than treating the private fund itself as the sole client).

[4]For example, if Fund Manager Y creates Fund X and gets Tom, Sally and Sara to invest in the fund X, then under the primary federal statute that regulates investment advisers, the Advisers Act, Fund X is Fund Manager Y's client. Conversely, Tom, Sally and Sara are not the Fund Manager Y's clients but rather investors in Fund Manager Y's clients. The distinction can be important as the fund manager generally has a duty to manage Fund X taking in consideration the objectives and interests of that Fund X as a whole and not the individual and perhaps varying objectives of the investors in Fund X.

[5]Other commentors objecting to the rules pointed that there is another statute that is designed to govern the relationship between the fund and investors, the Investment Company Act of 1940 (the "Investment Company Act") and that funds exempt from being treated as investment companies under the Investment Company Act of 1940 should not be regulated as if they were regulated funds. However, the SEC argued in the adopting release that it had the ability to implement interactions between a private fund and its investors under Section 211(h). Adopting Release at 35–38, 43.

[6]Id at 43–46

[7]For interesting discussion of how the focus under another securities law statute, the Securities Exchange Act has shifted from a primary disclosure based regulatory regime to more of a merit based regime, or a federalized corporate governance regime, see Mark I. Steinberg, The Federalization Of Corporate Governance (2018) and Mark I. Steinberg, Rethinking Securities Law (2021).

[8]15 U.S.C.A. §§ 80a-1 to 80a-64.

[9]Pub. L. No. 111-203.

[10]Exempt reporting advisers are investment advisers who are exempt from registration as an investment adviser by virtue of (i) exclusively advising private investment funds who have collectively less than $150 million in what is defined as "regulatory assets under management" or (ii) who solely advise what are "venture capital funds" (as defined in Rule 203(l)-1 under the Advisers Act). Exempt reporting advisers are also subject to incremental requirements under the Advisers Act that other exempt investment advisers are not generally subject to.

[11]A point of confusion among a lot of practitioners is that they think exempt advisers are exempt from the Advisers Act. That is not true, they are merely exempt from *registration* as an investment advisers, but still subject to a number of provisions under the Advisers Act and regulations issued thereunder, although not all of the regulations that apply to registered investment advisers.

[12]National Association of Private Fund Managers et. al. v. the SEC, Case No. 23-60471.

[13]Unpublished Order (Sept. 27, 2023) at Case No. 23-60471. The petitioners are requesting a discussion by the Fifth Circuit Court of Appeals by May 31, 2024. Petitioners' Unopposed Motion to Expedite (Sept. 15, 2023) at 10.

[14]15 U.S.C.A. § 80b-11.

[15]Dodd Frank § 913.

[16]*The Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

[17]*Id*. at 1148.

[18]For compliance purposes, the rules should be read themselves (as opposed

to summaries of them) as the rules contain a number of complexities and defined terms.

[19]Even then, this article will not go through every ambiguity, nuance or possible unintended consequence of each component of the Private Funds Rule. That would take a book, not a law review article. It also does not address record keeping requirements associated with a number of the rules.

[20]Accordingly, given the focus of this article on hitting upon certain nuances and consequences, it should not be viewed as a "compliance guide" or a comprehensive, detailed summary of the Private Funds Rule. As noted, there are a number of other sources that play that role.

[21]References to "rules" mean the different rules that collective make up the Private Funds Rule.

[22]17 C.F.R. § 275.206(4)-7.

[23]As noted, the remaining compliance dates for remaining provisions of the Private Funds Rule are phased in some cases depending on the size of the fund manager at issue. See Adopting Release Section IV pages 308–315 for further details on the compliance dates.

[24]As used in this article, references to a registered investment adviser will also be deemed to include references to an investment adviser who is required to registered. The SEC's regulatory approach is an adviser cannot avoid the regulatory reach of the Advisers Act by failing to register when it is otherwise required to register.

[25]The Private Fund Rules for "private fund" incorporates the definition of "private fund" as defined in Section 202(a)(29) of the Advisers Act as "an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 . . . but for section 3(c)(1) or 3(c)(7) of that Act." This article uses "private fund" and "private investment fund" interchangeably, but with the same meaning. A discussion of Section 3(c)(1) and 3(c)(7) of the Investment Company is beyond the scope of this article, but those two sections of the Investment Company Act are exemptions that private funds often rely upon for being exempt from being investment companies under the Investment Company Act.

[26]17 C.F.R. § 275.206(4)-2.

[27]Adopting Release at 185.

[28]A number of market participants overlook that just having an audit done by a member the PCAOB is not enough; the audit firm must also be subject to inspection by the PCAOB.

[29]The rule does not apply to "securitized asset funds" as defined in Rule 211(h)-1. A number of the private fund rules have exemptions for securitized asset funds. However, those are not discussed further in this article as securitized assets funds are beyond its scope.

[30]The particular reporting requirements are disclosed in Rule 211(h)-2 itself.

[31]15 C.F.R. § 275.206(4)-1.

[32]15 U.S.C.A. § 80b-6.

[33]15 C.F.R. § 275.206(4)-7.

[34]See In Matter of Wells Fargo Clearing Services LLC and Wells Fargo Advisors Financial Network, LLC, Security Exchange of 1934 Release No. 92331; Investment Advisers Act Release No. 6387 (Aug. 25, 2023) against Wells Fargo

saying that a violation of Advisers Act Section 206(2) generally prohibiting fraud, can be based on negligence.

[35]"Similar pool of assets," which is used throughout this article, has the meaning set forth in Rule 211(h)(1)-1.

[36]Rule 211(h)(2)-3(d) provides a "grandfathering exception" for funds that have commenced operations as of the compliance date and that have granted rights pursuant to an agreement before the compliance date if compliance would "require the parties to amend" such agreement.

[37]"Related person," used throughout this article, has the meaning set forth in Rule 211(h)(1)-1.

[38]As defined in Rule 211(h)(1)-1.

[39]As defined in Rule 211(h)(1)-1.

[40]Adopting Release at 293–94.

[41]*Id.* at 294, footnote 882.

[42]*Id*.

[43]In both cases, there is a limited "grandfathering exemption" for contractual agreements that were entered into prior to the applicable compliance date for funds that commenced operations prior to the compliance date if compliance would "require the parties to amend such agreements." Although the exemption would not apply to reimbursements in a case where there has been a sanction under the Advisers Act.

[44]Specifically, footnote 716 states "However, even in such circumstances where investigation fee and expense allocation provisions are highly negotiated, we believe such negotiation is only effective if investors explicitly consent to any such allocations in each specific instance."

[45]There is a limited grandfathering exemption similar to that which exists for Rule 211(h)(2)-1(a)(3) described in subsection (b) of the rule.

[46]Private Fund Advisers; Document of Registered Investment Adviser Compliance Reviews, SEC Release IA-5955 (Feb. 9, 2022).

[47]Metropolitan Life Ins. Co. V. Tremont Gp. Holdings, Inc. (Del. Ch. 2012).

[48] https://www.sec.gov/files/ia-6383-fact-sheet.pdf

[49]Adopting Release at 258–60.

[50]*Id*. at 260, footnote 782.

[51]*Id*. at 261.

[52]Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (July 12, 2019) at 11, footnote 31.

[53]Adopting Release at 257–58.

[54]*Id*. at 29 (citing *United States v. O'Hagan*, 521 U.S. 642, 667, 673 (1997).

[55]*United States v. O'Hagan*, 521 U.S. 642 (1997).

[56]*Id.* at 39, footnote 99.

[57]*Id*.

[58]*Id*.

[59]*Id*. at 32–35.

[60]Dodd Frank § 913.

[61]Dodd Frank § 913(g).

[62]Statement of Commissioner Hester M. Peirce, August 23, 2023, https://www.sec.gov/news/statement/peirce-statement-doc-registered-investment-adviser-compliance-reviews-08232023; Statement of Commissioner Mark T. Uyeda, August 23, 2023, https://www.sec.gov/news/statement/uyeda-statement-private-fund-advisers-082323.

[63]*West Virginia et al. v. Environmental Protection Agency et al.*, 142 S.Ct. 2587 (2022).

[64]*Id*. at 2594.

[65]*Id*. at 2616.

[66]*MCI Telecommunications Corp. v. American Telephone & Telegraph Co.*, 114 S.Ct. 2223 (1994).

[67]*FDA v. Brown & Williamson Tobacco Corp.*, 120 S.Ct. 1291 (2000).

[68]*Gonzales v. Oregon*, 126 S.Ct. 904 (2006).

[69]*National Federation of Independent Business v. OSHA*, 142 S.Ct. 661 (2022).

[70]Two commissioners seem to be taking the view that the Private Funds Rule is invalid under the Major Questions Doctrine.

"Had Congress given us the authority to impose a whole new regulatory framework for investment advisers, presumably it would have done so in Title IV of the Dodd-Frank Act, which Congress deemed the "Private Fund Investment Adviser Registration Act."[23] That private fund adviser title did not authorize us to take the interventionist measures in today's release, so now we scrounge around other provisions of Dodd-Frank for authority that does not exist." Uprooted: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Hester Peirce (Aug. 23, 2023) https://www.sec.gov/news/statement/peirce-statement-doc-registered-investment-adviser-compliance-reviews-08232023.

"Section 211(h)(2)'s heading is "Other Matters" and it is notable that Section 211(h) makes no mention of private funds at all. To uphold the Commission's reading, one would need to conclude that Congress intended for a subparagraph within Section 913(g)'s overall discussion of investment advisers and broker-dealers' duties to retail customers to have the effect of nullifying the regulatory treatment of private funds under the Advisers Act and Investment Company Act." Statement on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance, Mark T. Uyeda (Aug. 23, 2023) https://www.sec.gov/news/statement/uyeda-statement-private-fund-advisers-082323.

[71]The SEC addresses the *Goldstein* argument in the Adopting Release, but not explicitly with respect to the first part of Section 211(h). Adopting Release 43–44.

[72]Adopting Release at 30.

[73]*Id*.

[74]*Id*.

[75]Adopting Release at 31.

[76]*Id*.

[77]The SEC seems to be relying more on Section 206(4) for the Quarterly Statement Rule. "The quarterly statement rule is designed to facilitate the provision of simple and clear disclosures to private fund investors . . . namely what fees and expenses they will pay and what performance they receive."

Adopting Release at 31. The SEC uses the future tense "will," although the quarterly statements are actually provided once an investor is already an investor.

[78]*Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 2011).

[79]*Id*. at 1148.

[80]Securities Exchange Act, Section 3(g); Investment Company Act 2(c).

[81]*Id*. at 1148.

[82]*Id*.

[83]*Id*. at 1148–49.

[84]*Id*. at 1150.

[85]*Id*. *Compare* with *The Loan Syndications v. SEC*, 223 F.Supp.3d 37 (D.D.C. 2016), *overturned on other grounds*, 882 F.3d 220 (D.C. Cir. 2018) rejected an argument that the SEC had to adequately consider the economics of rule-making under different facts. The court noted that the SEC had apprised itself of the economic consequences of a regulation and noted the SEC did not have to quantify costs for which it could derive data.

[86]Adopting Release pp. 223–250.

[87]*Id*.

[88]*Id*. At 325.

[89]*Id*. at 346.

[90]*Id*. at 347.

[91]*Id*. at 340, 345.

[92]*Id*. at 346–47.

[93]*Id*. at 336–37

[94]*Id*. at 418–19.

[95]"Advisers may alternatively attempt to introduce substitute charges (for example, increased management fees) to cover the costs of compliance with the rule, but their ability to do so may depend on the willingness of investors to incur those substitute charges)"; *Id*. at 457 Adopting Release 527 ("Advisers may alternatively attempt to introduce substitute charges (for example, increased management fees) to cover the costs of compliance with the rule, but their ability to do so may depend on the willingness of investors to incur those substitute charges)" *Id*. at 527.