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COLLATERAL CONSEQUENCES: WHAT DOES THE EXPANDING ADVISERS ACT REGULATORY REGIME MEAN FOR PRIVATE FUND MANAGERS?

Last year, the U.S. Securities and Exchange Commission adopted landmark rulemaking impacting the $26.6 trillion private fund industry. While most are still navigating the nuances of the new rules, it is clear that the consequences will be global.

By Christine A. Schleppegrell and Thomas J. Crociata *

The private fund industry is currently experiencing the most seismic regulatory shift since the Dodd-Frank Act of 2010.[1] That Act required many private fund advisers to register for the first time and to consider their reporting obligations. Recent activity by the private fund industry's primary regulator in the United States, the Securities and Exchange Commission ("SEC"), has resulted in an enhanced burden for private fund managers as the agency attempts an overhaul of the traditional, disclosure-based regulatory regime. Within the last two years, the new rules adopted under the Investment Advisers Act of 1940 ("Advisers Act"), as amended, have expanded the body of rules under the Advisers Act by approximately 16%. Over 35% of advisers registered with the SEC are private fund managers[2] with $26.6 trillion in assets under management.[3]

Under SEC Chairman Clayton, the agency focused on expanding investor (including retail investor) access to the capital markets, including private funds.[4] In contrast, under SEC Chairman Gensler, the agency is focused on enhancing regulation of private funds and, some would argue, imposing restrictions that are similar to those placed on registered investment companies.[5] The SEC is advancing this overhaul through rulemaking, enforcement, and examinations of advisers to private funds. As detailed below, the SEC's rulemaking initiatives also stand to significantly impact advisers that

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, §§ 403, 404, 124 Stat, 1378, 1571-72 (July 2010), codified at 15 U.S.C. 80b-4(b).

[2] SEC Examination Priorities, Division of Examinations (Feb. 7, 2023), https://www.sec.gov/files/2023-exam-priorities.pdf.

[3] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 6383, at 9 (Aug. 23, 2023) ("Adopting Release"), https://www.sec.gov/files/rules/final/2023/ia-6383.pdf (data as of 2022).

[4] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Advisers Act Release No. 90300 (Nov. 2, 2020), https://www.sec.gov/rules/2020/11/facilitating-capital-formation-and-expanding-investment-opportunities-improving#33-10884.

[5] SEC Chairman Gensler, *Prepared Remarks at the Institutional Limited Partners Association Summit* (Nov. 10, 2021), https://www.sec.gov/news/speech/gensler-ilpa-20211110.

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are not registered with the SEC, including advisers located outside of the United States.

What follows is a discussion of recent regulatory developments that impact private fund advisers with a particular focus on advisers to private equity funds. However, many of these developments are equally applicable to other types of private funds, namely infrastructure, energy, private credit, and hedge funds and other private fund strategies. First, we provide an overview of rules the SEC has recently adopted and a preview of proposed rulemaking. Second, we discuss the current enforcement environment with a focus on electronic communications, marketing and advertising, fees/expenses, and safeguarding and gatekeepers. Finally, we analyze how this shifting landscape could impact business relationships, including negotiations between investors and private fund managers, as well as transactions and fundraising.

I. RULEMAKING ACTIVITY

Following a robust rulemaking agenda, the SEC, under Chairman Gensler, has finalized and proposed several initiatives of import to private fund managers. We discuss a few highlights below as well as a Financial Crimes Enforcement Network ("FinCEN") rulemaking that impacts private fund advisers.

A. Private Fund Adviser Rule — Finalized August 23, 2023

The SEC passed six new rules and amended two rules under the Advisers Act.[6] These substantial changes to the private fund regulatory regime will provide significant transparency for investors and visibility for the SEC into private funds. This rulemaking package ("PFA Rule") is primarily comprised of: (1) the Quarterly Statement Rule;[7] (2) the Audit Rule;[8] (3) the Adviser-Led Secondaries Rule;[9] (4) the Restricted Activities Rule;[10] and (5) the Preferential Treatment Rule.[11] The Quarterly Statement Rule, Audit Rule, and Adviser-Led Secondaries Rule will each apply only to private fund advisers that are registered (or required to be registered) with the SEC. The Restricted Activities Rule and Preferential Treatment Rule will apply to all advisers to private funds, regardless of an adviser's registration status (subject to certain nuances as discussed herein).[12]

The Quarterly Statement Rule will require an SEC-registered adviser to prepare a quarterly statement for each private fund that it advises (directly or indirectly) if such fund has had at least two full fiscal quarters of operating results.[13] The Audit Rule will require an SEC-

[6] Adopting Release, *supra* note 3; 17 C.F.R. § 275.211(h)(1)-1 provides defined terms for the five new rules.

[7] 17 C.F.R. § 275.211(h)(1)-2 ("Quarterly Statement Rule").

[8] 17 C.F.R. § 275.206(4)-10 ("Audit Rule").

[9] 17 C.F.R. § 275.211(h)(2)-2 ("Adviser-Led Secondaries Rule").

[10] 17 C.F.R. § 275.211(h)(2)-1 ("Restricted Activities Rule").

[11] 17 C.F.R. § 275.211(h)(2)-3 ("Preferential Treatment Rule").

[12] Based on the SEC's statements in the Adopting Release, the rules should not apply to a non-US adviser (regardless of SEC registration status) with respect to the adviser's funds that are domiciled outside of the United States, even if such funds have US investors. Non-US advisers with both onshore and non-US funds should, nonetheless, be mindful of the "similar pool of assets" provision in the preferential treatment rule. *See also,* Christine A. Schleppegrell, Joshua B. Gurney, et al., *SEC Adopts New Private Fund Adviser Rules with Nuanced Application to Non-US Advisers,* Morgan, Lewis & Bockius LawFlash (Sept. 22, 2023), https://www.morganlewis.com/pubs/2023/09/sec-adopts-new-private-fund-adviser-rules-with-nuanced-application-to-non-us-advisers.

[13] 17 C.F.R. § 275.211(h)(1)-2; *see also,* Adopting Release, *supra* note 3, at 59-60 ("The quarterly statement rule is designed to facilitate the provision of simple and clear disclosures to investors regarding some of the most important and fundamental terms of their relationships with investment advisers to private funds in which those investors invest — namely what fees and expenses those investors will pay and what performance they receive on their private fund investments. These disclosures will allow investors to better understand their private fund investments and the terms of their relationship with the adviser to those funds.").

registered adviser that advises (directly or indirectly) one or more private funds to cause each private fund to obtain audited financial statements in accordance with the audit provisions (and related requirements for delivery of audited financial statements) set forth in Rule 206(4)-2 under the Advisers Act (the "Custody Rule").[14] Most private funds already provide investors with audited financial statements in order to comply with the Custody Rule. The Adviser-Led Secondaries Rule will require an SEC-registered adviser that advises one or more private funds to provide to investors, prior to the due date of the applicable investor election form for such an adviser-led secondary transaction, (1) a fairness opinion or a valuation opinion from an independent opinion provider and (2) a summary of any material business relationships the adviser or any of its related persons has, or has had, with the independent opinion provider, during the two-year period immediately prior to the issuance of such opinion.[15]

The Restricted Activities Rule will prohibit all advisers to private funds[16] from engaging in certain practices unless they meet prescribed disclosure requirements, and in some cases, receive investor consent, among other conditions.[17] The Preferential Treatment Rule consists of two main parts: a prohibitions portion and a disclosure portion.[18] First, the Preferential Treatment Rule will prohibit all advisers to private funds from providing preferential liquidity terms to a subset of investors in a private fund or a similar pool of assets if the adviser reasonably expects such treatment to have a material, negative effect on other investors in the private fund or similar pool of assets. There are certain limited exceptions to this prohibition. The rule will also prohibit all advisers to private funds from providing to a subset of private fund investors information about portfolio holdings or exposures of the private fund or a similar pool of assets if the adviser reasonably expects that providing such information will have a material, negative effect on other investors in the private fund or a similar pool of assets. There is an exception to the prohibition if the adviser offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially at the same time. Second, the disclosure portion of the rule will prohibit an adviser from providing any preferential treatment to investors in a private fund unless the adviser provides written notice to such investors at three specific time periods. Each of the two parts of the Preferential Treatment Rule has a different scope: the prohibitions portion of the rule has a broad scope and applies to an adviser's private funds and all "similar pools of assets."[19] In contrast, the disclosure

[14] 17 C.F.R. § 275.206(4)-10; *see also,* Adopting Release, *supra* note 3, at 159 ("In addition to protecting the fund and its investors against the misappropriation of fund assets, we believe an audit by an independent public accountant provides an important check on the adviser's valuation of private fund assets, which often serves as the basis for the calculation of the adviser's fees. It also provides an important check on certain conflicts of interest between the adviser and the private fund investors, such as potentially problematic sales practices or compensation schemes.").

[15] Adopting Release, *supra* note 3, at 183 ("Advisers or their related persons have a conflict of interest with the fund and its investors when they offer investors the option between selling their interests in the fund, and converting or exchanging their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. This rule will provide an important check against an adviser's conflicts of interest in structuring and leading such a transaction from which it may stand to profit at the expense of private fund investors.").

[16] This rule applies to all investment advisers, regardless of whether they are registered with the SEC, relying on an exemption from registration (including, but not limited to, exempt reporting advisers), registered with one or more state securities regulators, or based in the United States but entirely unregistered.

[17] 17 C.F.R. § 275.211(h)(2)-1; *see also,* Adopting Release, *supra* note 3, at 205 ("We continue to believe that these activities involve conflicts of interest [. . .] and compensation schemes [. . .] that are contrary to the public interest and protection of investors. In addition, adopting protective restrictions on these activities is reasonably designed to prevent fraud and deception. Many of our concerns with these activities have persisted despite our related enforcement actions, and we believe therefore that further regulation is required.").

[18] 17 C.F.R. § 275.211(h)(2)-3; *see also,* Adopting Release, *supra* note 3, at 261 ("Granting preferential treatment is a conflict of interest because advisers have economic and/or other business incentives to provide preferential terms to one or more investors (e.g., based on the size of the investor's investment, the ability of the investor to provide services to the adviser, or the potential to establish or cultivate relationships that have the potential to provide benefits to the adviser). These incentives have the potential to cause the adviser to provide preferential terms to one or more investors that harm other investors or otherwise put the other investors at a disadvantage.").

[19] 17 C.F.R. § 275.211(h)(1)-1. Defined as a "pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940, a company that elects to be regulated as such, or a securitized asset fund) with substantially

portion of the rule only applies to private funds managed by an adviser.

The rulemaking package included amendments to two existing rules under the Advisers Act. Advisers are now required to document, in writing, the annual review of their compliance policies and procedures.[20] In addition, the SEC amended Rule 204-2 under the Advisers Act (the "Recordkeeping Rule") to require advisers to maintain new records related to the PFA Rule.[21]

The deadlines for implementing the PFA Rule are immediately below.

1. Audit Rule – March 14, 2025

2. Quarterly Statement Rule – March 14, 2025

3. Adviser-Led Secondaries Rule – Staggered depending on adviser's private fund AUM:[22]

   a) $1.5 billion or more—September 14, 2024 (Note: this is a Saturday)

   b) Less than $1.5 billion—March 14, 2025

4. Preferential Treatment Rule – Staggered depending on adviser's private fund AUM:

   a) $1.5 billion or more—September 14, 2024 (Note: this is a Saturday)

   b) Less than $1.5 billion—March 14, 2025

5. Restricted Activities Rule – Staggered depending on adviser's private fund AUM:

   a) $1.5 billion or more—September 14, 2024 (Note: this is a Saturday)

   b) Less than $1.5 billion—March 14, 2025

6. Written Annual Review Amendments – November 13, 2023

With compliance dates now settled, and on the horizon, the industry is navigating interpretive issues. Some of the most significant concerns for private fund managers, particularly managers of private equity funds, are as follows:

1. Quarterly Statement Rule: Calculating performance based on specific guidelines and determining whether to align with performance included in marketing materials. Determining the scope of the quarterly statement and whether to include "similar pools of assets" in order to provide "meaningful information" to investors.

2. Adviser-Led Secondaries Rule: Scoping which types of transactions fall within the definition, and even for transactions that are technically out of scope of this definition, determining how to handle conflicts of interest in light of the SEC's statements in the Adopting Release and recent enforcement activity.

3. Restricted Activities Rule: Considering how the restriction on charging or allocating fees and expenses related to a portfolio investment on a non-pro rata basis impacts co-investment vehicles and the allocation of broken deal expenses. For example, if an adviser's private fund and co-investment vehicle invest in the same portfolio company, how is the adviser allocating expenses, and what are the adviser's economics in both the private fund and the co-investment vehicle?

4. Preferential Treatment Rule: Parsing the "similar pool of assets" definition, noting that this term could scope in co-investment vehicles, parallel funds, and alternative investment vehicles.[23] Assessing how

footnote continued from previous page…

similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons.").

[20] 17 C.F.R. § 275.206(4)-7(b); Adopting Release, *supra* note 3. This amendment impacts all SEC registered advisers, not only advisers to private funds.

[21] 17 C.F.R. § 275.204-2. This includes new recordkeeping requirements for the Quarterly Statement Rule, Audit Rule, Adviser-Led Secondaries Rule, Restricted Activities Rule, and Preferential Treatment Rule.

[22] Adopting Release, *supra* note 3, at 307 ("An adviser's private fund assets under management are the portion of such adviser's regulatory assets under management that are attributable to private funds it advises.").

[23] The SEC cautions that "the definition will likely capture vehicles outside of what the private funds industry would typically view as 'substantially similar pools of assets.'" According to the SEC, "an adviser's healthcare-focused private fund may be considered a 'similar pool of assets' to the adviser's technology-focused private fund under the definition." Adopting Release, *supra* note 3, at 286-7; *see also,* Adopting Release, *supra* note 3, at 289-90 for discussion of co-investment funds.

prohibitions on preferential redemption and preferential information could apply to closed-end funds (illiquid funds) which generally do not allow periodic redemptions. The SEC helpfully stated (albeit with caveats) that information provided to an investor in an illiquid fund generally would not trigger the material, negative effect language in the rule.[24]

One of the most impactful parts of the PFA Rule is the Preferential Treatment Rule (also known as the side letters rule), which has already begun to alter negotiations between investors and fund managers. The rule prohibits certain types of preferential treatment (e.g., providing certain types of redemption rights and providing certain types of information about a private fund's portfolio holdings or exposures)[25] and requires disclosure (with specificity) of all other preferential treatment. Fund managers and investors are currently analyzing what this new transparency provision means for ongoing side letter negotiations, post-compliance date disclosure obligations (including disclosure of existing preferential treatment), and the impact on customized disclosure that investors previously negotiated for. In addition, managers are considering how best to coordinate with their investor relations and business teams.

On September 1, 2023, six trade associations challenged the validity of the PFA Rule by filing a petition in the United States Court of Appeals for the Fifth Circuit. The trade associations claimed that these new rules exceeded the SEC's statutory authority. They argued that the new rules were adopted without compliance with the "notice-and-comment requirements, and are otherwise arbitrary, capricious, an abuse of discretion, and contrary to law, all in violation of the Administrative Procedure Act."[26] Despite the lawsuit, most advisers and investors are working toward implementation, given the short timeline.

B. Form PF Rule Amendments — Finalized May 3, 2023 and July 12, 2023

Through two separate rulemakings, the SEC amended Form PF.[27] This development impacts large hedge fund advisers, private equity fund advisers, large private equity fund advisers, and large liquidity fund advisers.[28] The Form PF amendments require (1) current reporting as soon as practicable and, in any event, within 72 hours for large hedge fund advisers of certain triggering events with respect to their qualifying hedge funds; (2) event reporting for all private equity fund advisers on a quarterly basis of certain fund- and adviser-level triggering events; (3) certain increased and additional reporting for all large private equity fund advisers including reporting of any clawback events; and (4) additional information from large liquidity fund advisers, including operational information, assets and portfolio information, additional repo reporting, and subscriptions/redemptions data.

The most significant development for private equity fund advisers is the requirement to file reports on a quarterly basis when certain triggering events occur. All private equity fund advisers are now required to report to the SEC within 60 days after quarter end if, during such

[24] Adopting Release, *supra* note 3, at 285.

[25] These prohibitions also extend to any "similar pools of assets" managed by an adviser or its related persons.

[26] National Association of Private Fund Managers, et al. v. Securities and Exchange Commission, Petition for Review, (Sept. 1, 2023) Case — 23-60471, https://www.managedfunds.org/wp-content/uploads/2023/09/MFA-Filing.pdf.

[27] Amendments to Form PF to Require Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers and to Amend Reporting Requirements for Large Private Equity Fund Advisers, Advisers Act Release No. 6297 (May 3, 2023), https://www.sec.gov/rules/final/2023/ia-6297.pdf; Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to Form N-CSR and Form N-1A, Advisers Act Release No. 6344 (July 12, 2023), https://www.sec.gov/files/rules/final/2023/33-11211.pdf. Form PF is a confidential, non-public form that investment advisers file with the SEC. Investment advisers are required to complete and file a Form PF if such adviser (1) is registered or is required to register with the SEC as an investment adviser or is registered or required to register with the Commodity Futures Trading Commission, (2) manages one or more private funds, and (3) has at least $150 million in private fund assets under management as of the last day of its most recently completed fiscal year.

[28] Large hedge fund advisers are advisers with at least $1.5 billion in regulatory assets under management attributable to hedge funds as of the last day of any month in the fiscal quarter immediately preceding the adviser's most recent fiscal quarter. Large private equity fund advisers are advisers with at least $2 billion in regulatory assets under management attributable to private equity funds as of the last day of the adviser's most recent fiscal year. Large liquidity fund advisers are advisers with at least $1 billion in combined liquidity fund and money market fund assets under management as of the last day of any month in the fiscal quarter immediately preceding the adviser's most recent fiscal quarter.

quarter, either of the following occurred: (1) an adviser-led secondary transaction or (2) general partner removal, termination of a fund's investment period, or termination of a fund. Notably, this new reporting obligation applies to all private equity fund advisers and is NOT limited to large private equity fund advisers. In addition, large private equity fund advisers are required to report additional information to the SEC, including details about general partner and limited partner clawbacks, the private equity fund's investment strategies, and information about fund-level borrowings.

Compliance with the new current reporting obligations was required as of December 11, 2023, and advisers must comply with all other amendments starting June 11, 2024.

C. Form N-PX Reporting for Institutional Investment Managers — Finalized November 2, 2022

The SEC adopted a new rule under the Securities Exchange Act of 1934, as amended, as well as amendments to Form N-PX, a form historically only used by advisers to mutual funds, exchange-traded funds, and certain other registered funds to report information about their proxy votes. In a change, institutional investment managers[29] that file on Form 13F are now required to make public filings on Form N-PX to report their "say-on-pay" proxy voting. Going forward, this report must be filed no later than August 31 of each year and must cover the most recent one-year period running from July 1 to June 30. Although advisers will not be required to make their first filing until August 31, 2024 (covering the period from July 1, 2023 to June 30, 2024), advisers must retain voting information starting July 1, 2023.

D. Corporate Transparency Act — Finalized September 30, 2022

FinCEN, a bureau of the US Department of the Treasury and the US Financial Intelligence Unit, published a final rule about reporting beneficial ownership information.[30] The new rule requires certain reporting companies to disclose to FinCEN certain personal information of each beneficial owner[31] and company applicant.[32] Reporting companies include (but are not limited to) any entity that is (1) a corporation, (2) a limited liability company ("LLC"), or (3) created by the filing of a document with a secretary of state of any similar office under the law of a state or American Indian tribe.[33] There are several exemptions from the reporting requirement, including exemptions for SEC-registered investment advisers, venture capital fund advisers, and the private funds they manage.[34] Notably, there is not an explicit exemption for exempt reporting advisers ("ERAs") or state-registered advisers based on their status as such.

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[29] Barry N. Hurwitz and Amy C. McDonald, New SEC Rule Requires 13F Filers to Track and Report on Proxy Voting, Morgan, Lewis & Bockius LLP, LawFlash (June 21, 2023), https://www.morganlewis.com/pubs/2023/06/new-sec-rule-requires-13f-filers-to-track-and-report-on-proxy-voting#_ftn1. ("An 'institutional investment manager' is defined in the Adopting Release as an entity that either invests in, or buys and sells, securities for its own account. The term 'institutional investment manager' also includes a natural person or an entity that exercises investment discretion over the account of any other natural person or entity (for example, an investment adviser). A natural person or entity that controls an institutional investment manager is itself an institutional investment manager."); *See also,* Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, Advisers Act Release No. 96206 (Nov. 2, 2022), https://www.sec.gov/files/rules/final/2022/33-11131.pdf.

[30] Beneficial Ownership Information Reporting Requirements, 87 Fed. Reg. 59,498, 59,543 (Sept. 30, 2022) ("CTA Rule Adopting Release"). These new rules implement parts of the Corporate Transparency Act, which was enacted into federal law in January 2021.

[31] A "beneficial owner" is any individual who exercises "substantial control" over the reporting company or who owns or controls a 25% "ownership interest" in the reporting company. Both terms are further defined in the final rule.

[32] A "company applicant" is any individual who directly files the document that creates the domestic reporting company or registers the foreign reporting company, and the individual who is primarily responsible for directing or controlling such filing if more than one individual is involved in the filing.

[33] There are two main types of reporting companies: domestic reporting companies and foreign reporting companies. A domestic reporting company is any entity that is (1) a corporation, (2) LLC, or (3) created by the filing of a document with a secretary of state of any similar office under the law of a state or American Indian tribe. A foreign reporting company is any entity that is (1) a corporation, LLC, or other entity, (2) formed under the law of a foreign country, and (3) registered to do business in any state or tribal jurisdiction by the filing of a document with a secretary of state of any similar office under the law of a state or American Indian tribe.

[34] In terms of private funds, the exemption only applies to funds that rely on Section 3(c)(1) or (7) of the Investment Company Act.

Reporting companies created on or registered to do business before January 1, 2024 must file their initial beneficial ownership information reports by January 1, 2025. Reporting companies created or registered to do business in 2024 must file their initial reports within 90 calendar days of the earlier of (1) the date on which they receive actual notice that their creation has become effective (in the case of a domestic reporting company) or they have been registered to do business (in the case of a foreign reporting company) or (2) the date on which a secretary of state or similar office first provides public notice. Reporting Companies created or registered on or after January 1, 2025 will have 30 calendar days to file their reports.[35]

Certain states have begun to pass or propose similar statutes in order to create state-level databases of beneficial ownership information. The New York state legislature recently passed the LLC Transparency Act, and the next step is approval by the governor.[36] In contrast to the CTA, the New York law would make certain beneficial ownership information public. California proposed its own version of the CTA which would require reporting beneficial ownership information to the secretary of state.[37]

E. What's Next?

According to the SEC's most recent rulemaking agenda,[38] the agency is working to finalize the following initiatives that are of interest to private fund managers: (1) cybersecurity, (2) outsourcing, (3) safeguarding advisory client assets (i.e., Custody Rule amendments), (4) fund and adviser ESG, (5) Regulation S-P, (6) predictive data analytics and artificial intelligence, and (7) additional amendments to Form PF.

[35] Beneficial Ownership Information Reporting Deadline Extension for Reporting Companies Created or Registered in 2024, 88 FR 83499 (Nov. 30, 2023).

[36] LLC Transparency Act, Assemb. A03484, 2023 Sess. (N.Y. 2023-2024), https://nyassembly.gov/leg/?default_fld=&leg_video=&bn=A03484&term=&Actions=Y&Text=Y; LLC Transparency Act, Sen, S00995, 2023 Sess. (N.Y. 2023-2024), https://nyassembly.gov/leg/?default_fld=&leg_video=&bn=S00995&term=&Text=Y (June 20, 2023).

[37] Corporate Transparency Act: Foreign Corporations: Certificate of Qualification, SB-738 (Feb. 17, 2023), https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB738.

[38] Office of Management and Budget, Securities and Exchange Commission, Agency Rule List – Fall 2023 (Dec. 6, 2023).

II. SEC ENFORCEMENT TRENDS

On the enforcement front, the SEC has increasingly focused its investigative efforts on private funds. Below we discuss recent actions against private fund advisers in four main categories: electronic communications and recordkeeping, marketing and advertising, fee and expense disclosure, safeguarding, and gatekeeper liability.

A. Electronic Communications

Over the last couple of years, the SEC has continued its focus on electronic communications and Recordkeeping Rule violations. According to the SEC's Director of Enforcement, "[e]nhancing [corporate responsibility] will require, among other things, robust enforcement of laws and rules concerning required disclosures. . .[and]. . .violation of record-keeping obligations."[39]

In September 2022, the SEC brought several enforcement actions against broker-dealers, dual registrants, advisers with affiliated broker-dealers, and investment advisers. The SEC announced charges against 15 broker-dealers and one investment adviser for failures by the firms and employees to maintain and preserve electronic communications. Fines totaled over $1.1 billion.[40] While most of the firms were broker-dealer firms, one firm was dually registered with the SEC as both a broker-dealer and investment adviser.[41] In August 2022, the SEC settled with an investment adviser who was not affiliated with a broker-dealer and was not a dual registrant.[42] However, the off-channel communications component was not central to the settlement, which instead focused on other activity.

More recently, in August 2023, the SEC announced charges against 11 firms resulting in fines of $289

[39] Gurbir Grewal, *Remarks at SEC Speaks 2021*, https://www.sec.gov/news/speech/grewal-sec-speaks-101321#_ftnref11.

[40] Press Release, SEC Charges 16 Wall Street Firms with Widespread Recordkeeping Failures (Sept. 27, 2022), https://www.sec.gov/news/press-release/2022-174.

[41] *In the Matter of Wedbush Securities Inc.*, Advisers Act Release No. 6369 (Aug. 3, 2022) (settled action) ("Wedbush Settlement"), https://www.sec.gov/files/litigation/admin/2023/34-98074.pdf.

[42] *In the Matter of Deccan Value Investors LP*, Advisers Act Release No. 6079 (Aug. 3, 2022) (settled action), https://www.sec.gov/files/litigation/admin/2022/ia-6079.pdf.

million.[43] In this second round of enforcement actions, only one involved an investment adviser, in this case, a dual registrant.[44] Of particular concern is that the settlement orders discuss "internal" communications and include these when defining "off-channel communications." In addition, the orders only mention Rule 204-2(a)(7), which subsection of the Recordkeeping Rule does not cover *internal* communications of an adviser. As a result, it is unclear what the SEC's legal basis is for scrutinizing an adviser's *internal* communications, and this enforcement activity suggests that the SEC is interpreting and applying the Recordkeeping Rule beyond its textual boundaries. Another concern is that the settlement involving the investment adviser mentions "off-channel communications that related to the business of the . . .registered investment adviser," "communications related to the business" of the adviser, and "communicating. . .about [the adviser's]. . .investment adviser business [. . .]."[45] However, the settlement does not cite any legal requirement to retain all communications *related to the business of an adviser*. These actions illustrate the SEC's aggressive interpretation of the Recordkeeping Rule. Advisers have reportedly received requests from the Division of Enforcement about their practices related to off-channel communications.

B. Marketing Rule

Following FAQs[46] and two risk alerts,[47] the Division of Enforcement recently brought actions against advisers for failure to comply with Rule 206(4)-1 under the Advisers Act (the "Marketing Rule").[48]

In August 2023, the SEC announced the first enforcement action against an adviser for violating the Marketing Rule. The SEC alleged that a fintech adviser that primarily served retail clients violated the rule's hypothetical performance provisions and displayed hypothetical performance on the adviser's public website.[49]

Shortly thereafter, in September 2023, the SEC brought charges against nine registered investment advisers for advertising hypothetical performance, specifically model and backtested performance, to the general public on their websites.[50] Certain of the enforcement actions also included Recordkeeping Rule violations. The Division of Enforcement staff explained the focus on hypothetical performance, stating that "[b]ecause of their attention-grabbing power, hypothetical performance [. . .] may present an elevated risk for prospective investors [. . .] we will remain vigilant and continue our ongoing sweep to ensure that investment advisers comply with the Marketing Rule, including the requirements for hypothetical performance."[51]

Marketing Rule compliance is ongoing and advisers to private funds continue to navigate issues including: calculating net performance at the individual portfolio company level and calculating net performance for portfolio extracts; determining which types of performance-related metrics (i.e., performance attribution, yield, Sharpe ratio) are considered performance that must be shown net; presenting case studies in a matter that satisfies the general prohibitions; identifying hypothetical performance and ensuring that such materials are directed toward the appropriate

[43] Press Release, SEC Charges 11 Wall Street Firms with Widespread Recordkeeping Failures (Aug. 8, 2023), https://www.sec.gov/news/press-release/2023-149.

[44] Wedbush Settlement.

[45] *Id.*

[46] Marketing Compliance Frequently Asked Questions (Updated Jan. 11, 2023), https://www.sec.gov/investment/marketing-faq.

[47] Risk Alert, Examinations Focused on Additional Areas of the Adviser Marketing Rule (June 8, 2023), https://www.sec.gov/files/risk-alert-marketing-rule-announcement-phase-3-060823.pdf; *see also*, Risk Alert, Examinations Focused on the New Investment Adviser Marketing Rule (Sept. 19, 2022), https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf.

[48] The SEC adopted the Marketing Rule on December 22, 2020. The rule applies to SEC-registered advisers and compliance was required as of November 4, 2022. Investment Adviser

footnote continued from previous column…

Marketing, Advisers Act Release No. 5653 (Dec. 22, 2020), https://www.sec.gov/files/rules/final/2020/ia-5653.pdf.

[49] Press Release, SEC Charges FinTech Investment Adviser Titan for Misrepresenting Hypothetical Performance of Investments and other Violations (Aug. 21, 2023), https://www.sec.gov/news/press-release/2023-153; *see also*, *In the Matter of Titan Global Capital Management USA LLC*, Advisers Act Release No. 6380 (Aug. 21, 2023) (settled action), https://www.sec.gov/files/litigation/admin/2023/ia-6380.pdf.

[50] Press Release, SEC Sweep into Marketing Rule Violations Results in Charges Against Nine Investment Advisers (Sept. 11, 2023), https://www.sec.gov/news/press-release/2023-173.

[51] *Id.*

audience (i.e., the intended audience); and obtaining books and records to satisfy the predecessor performance provisions. In addition to these compliance hurdles, private fund managers will also need to consider how performance in their marketing materials will (or will not) overlap with performance metrics included in the new quarterly statements.[52]

C. Fees and Expenses

The SEC continues to focus on private fund advisers' fee and expense disclosures and associated conflicts of interest. In addition to tackling this issue from the rulemaking front with the PFA Rule (specifically the Quarterly Statement Rule and the Restricted Activities Rule), the Division of Enforcement has been especially active in this space.

In June 2023, the SEC announced a settlement against a private equity fund adviser for overcharging management fees and failing to disclose conflicts of interest associated with management fee calculations.[53] The SEC found that the adviser did not follow the provisions in the fund governing documents for fee calculations, specifically that the adviser did not correctly apply criteria for determining whether an investment had been permanently impaired. According to the SEC, this failure resulted in the adviser overcharging management fees to the fund. Additionally, the SEC found that the adviser did not disclose the "significant latitude" that it had in making certain determinations under the fund documents and how those determinations could impact management fee calculations.

In September 2023, the SEC announced a settlement against a private equity fund adviser that was not registered with the SEC for inadequate disclosure of, and material misstatements about, fees paid to an affiliate.[54] According to the SEC, the adviser failed to disclose millions of dollars in real estate brokerage fees that were paid to an affiliated entity that was wholly owned by the CEO of the adviser. Specifically, the SEC found that the adviser's disclosures in offering materials and responses in both the adviser's generic due diligence questionnaire ("DDQ") and investor specific DDQs did not adequately capture the conflicts of interest associated with this fee stream. The SEC stated that "[f]unds, including those that invest in alternative asset classes, must ensure that their offering materials contain clear, accurate, and adequate disclosures."[55]

D. Safeguarding and Gatekeepers

In a series of two sweeps spaced one year apart, the SEC identified failures of advisory firms to comply with the Custody Rule.

In September 2022, the SEC settled with nine advisory firms for Custody Rule shortcomings, including failure to cause the private fund to undergo a financial statement audit, failure to deliver audited financial statements in a timely manner, and failure to timely amend Form ADV to indicate receipt of the audited financial statements.[56] The advisers settled with the SEC and agreed to pay combined penalties of $1 million.

In September 2023, the SEC settled with five advisory firms for Custody Rule deficiencies, including failure to cause the private fund to undergo a financial statement audit, failure to deliver audited financial statements in a timely manner, failure to ensure assets were maintained with a qualified custodian, and failure to timely amend Form ADV to indicate receipt of the audited financial statements.[57] The advisers settled with the SEC and agreed to pay combined penalties of more than $500,000.

In December 2023, the SEC settled with an adviser for activity related to paper membership interests in real estate funds managed by the adviser as well as other Custody Rule failures.[58] According to the SEC, the adviser had custody of paper membership interests in the

[52] While in some cases new rules adopted after the Marketing Rule may create compliance challenges, in other cases, they may provide clarification. *See, e.g.,* Adopting Release, *supra* note 3, at 46-50.

[53] *In the Matter of Insight Venture Management, LLC*, Advisers Act Release No. 6332 (June 20, 2023) (settled action), https://www.sec.gov/files/litigation/admin/2023/ia-6332.pdf.

[54] *In the Matter of Prime Group Holdings, LLC*, Securities Act Release No. 11228 (Sept. 5, 2023) (settled action), https://www.sec.gov/files/litigation/admin/2023/33-11228_0.pdf.

[55] *Id.*

[56] Press Release, SEC Charges Two Advisory Firms for Custody Rule Violations, One for Form ADV, and Six for Both (Sept. 9, 2022), https://www.sec.gov/news/press-release/2022-156.

[57] Press Release, SEC Charges Five Advisory Firms for Custody Rule Violations (Sept. 5, 2023), https://www.sec.gov/news/press-release/2023-168.

[58] *In the Matter of Eagan Capital Management, LLC*, Advisers Act Release No. 6491 (Dec. 1, 2023) (settled action), https://www.sec.gov/files/litigation/admin/ 2023/ia-6491.pdf.

private funds it managed and held those interests for advisory clients that invested in the funds. The SEC found that the adviser failed to obtain a surprise examination with respect to client funds and securities, including the membership interests. With respect to the private funds, the SEC similarly found that the adviser failed to comply with the Custody Rule, including the audit provision.

The SEC also recently brought charges against gatekeepers for private funds, including auditors and administrators.[59] In March 2023, the SEC settled with an audit firm for failing to address significant fraud risks associated with the valuation of investments in two private funds.[60] According to the SEC, the audit firm supported an SEC-registered investment adviser's valuation methodology despite acknowledging the fraud risk associated with this valuation approach. In addition, the audit firm failed to obtain supporting evidence for the assumptions used in the valuation model. The SEC concluded that the audit firm did not meet professional standards and that the engagement partner for the audit did not appropriately supervise the audit.

In August 2023, the SEC settled with a fund administrator for serving as a cause of an unregistered investment adviser's violation of Section 206(4) of the Advisers Act.[61] The fund administrator took direction from the adviser to report fund losses in an incorrect manner that resulted in an incorrect (and inflated) fund NAV. The administrator provided investors with statements that materially misstated the fund NAV. According to the SEC, the administrator did not evaluate whether the accounting approach the adviser directed it to use was appropriate and ignored red flags. These enforcement actions against private fund gatekeepers come at a time when advisers are increasingly relying on service providers to help shoulder the immense and growing regulatory burden. These actions are thematically on point with the SEC's current focus on pursuing service providers and other third parties as another avenue to regulate the activity of advisers.[62]

III. IMPACT ON THE PRIVATE FUND INDUSTRY AND TRANSACTIONS

How can private fund managers best navigate this aggressive examination and enforcement environment coupled with uncertainty about key regulations?

In terms of regulatory compliance, open interpretive issues, including those raised by the PFA Rule, will significantly impact how an adviser structures its adviser entities and its fund complex. For example, advisers are currently analyzing funds-of-one and considering their status under the new PFA Rule, specifically whether such "funds" are better characterized as separately managed accounts. Advisers are also assessing the definition of "similar pool of assets" and considering what other products on their shelves have "substantially similar" policies, objectives, or strategies. Advisers are undergoing this scoping exercise to determine the complete impact of the PFA Rule. Given the dearth of interpretive guidance over the last several years, managers are navigating the fine line between creative structuring to avoid or lessen the impact of burdensome regulation and activity that the SEC could view as attempted circumvention of the Advisers Act regulatory regime.[63] In terms of the scope and types of investment advisers impacted, both recent rulemakings and enforcement activity suggest that the SEC is broadly focused on investment advisers, including those that are not SEC-registered.[64]

In terms of the deal environment, the regulatory atmospherics will impact secondary transactions/continuation funds, co-investment vehicles, fundraising, and negotiations between managers and investors. The SEC's focus on adviser-led transactions, whether or not they meet the formal definition of an "adviser-led secondary transaction" in the PFA Rule, has

[59] In these actions, the SEC refers to these "critical" and "important" gatekeepers.

[60] *In the Matter of Spicer Jeffries LLP and Sean P. Tafaro, CPA*, Securities Exchange Act Release No. 97216 (Mar. 29, 2023) (settled action), https://www.sec.gov/files/litigation/admin/2023/34-97216.pdf.

[61] *In the Matter of Theorem Fund Services, LLC*, Advisers Act Release No. 6367 (Aug. 7, 2023) (settled action), https://www.sec.gov/files/litigation/admin/2023/33-11218.pdf.

[62] Outsourcing by Investment Advisers, Advisers Act Release No. 6176 (Dec. 27, 2022), https://www.sec.gov/rules/2022/10/outsourcing-investment-advisers.

[63] The Adopting Release for the private fund adviser rules cautions against circumventing the new rules and includes five references to Section 208(d) of the Advisers Act. *See* Adopting Release, *supra* note 3.

[64] Adopting Release, *supra* note 3, at 46-8; *see also*, Press Release, SEC Charges Private Equity Firm Prime Group for Inadequate Disclosure of Fees Paid to Affiliate (Sept. 5, 2023), https://www.sec.gov/news/press-release/2023-167.

caused managers to be highly sensitive to the conflicts associated with a transaction initiated by the manager where the manager (or an affiliate) benefits economically. The SEC is likely to view secondary transactions with skepticism, especially transactions that occur early in the fund's term. Even in circumstances where the adviser does not initiate the transaction and is instead acting at an investor's request, fairness concerns may be top of mind. Managers that are currently working through an adviser-led transaction may consider how regulators will view transactions in hindsight, especially after the PFA Rule compliance date.

In the current challenging fundraising environment, investors in certain funds may have more leverage and negotiating power. But, the PFA Rule, namely the Preferential Treatment Rule, will complicate manager and investor interactions. In ongoing negotiations between investors and managers, especially for side letters, both parties are analyzing the many open interpretive issues. While some investors view managers as having the "right of first interpretation" when it comes to the PFA Rule, other investors are preparing to advance their own interpretations in an effort to leverage the protective aspects of the new rule. Even though the compliance dates for the PFA Rule are months away, many managers and investors are finding that the Preferential Treatment Rule in particular has an immediate impact on day-to-day negotiations even pre-compliance date. It remains to be seen how and whether fund documents will evolve in response to the new rules: as side letter negotiations become more challenging, will important terms migrate to the fund's governing documents? Will investors be able to retain terms they previously negotiated for (e.g., special reporting, additional transparency) or will the friction caused by the Preferential Treatment Rule compromise these rights?

It is possible that the onslaught of regulation impacting private fund managers will drive consolidation. Private fund managers, both large and small, believe that increased regulation favors larger managers with the resources to engage with increased compliance requirements. It seems the SEC agrees, hence the staggered compliance dates for some aspects of the new PFA Rule.[65] Smaller managers that find themselves unable to shoulder ever-increasing regulatory obligations may decide to consolidate in order to leverage larger firms with a robust compliance department and achieve economies of scale.

Looking beyond the private fund manager's viewpoint, not all private fund investors find the new wave of regulation helpful. Many investors are concerned about the possible negative impact of the new PFA Rule, specifically the potential decrease in available advisers due to consolidation and other factors discussed above. In addition, investors — especially larger investors — are concerned about the impact of the new rules on side letters. The movement away from a disclosure-based and principles-based regime toward more prescriptive rules has resulted in what some view as a one-size-fits-all approach to regulating a diverse industry that ranges from small to large investors (with very different investor protection concerns), as well as a variety of private funds in terms of strategy, size, and manager type.

Because private fund offerings are increasingly global and require multi-jurisdictional regulatory compliance, managers with an international footprint are also faced with reconciling the new PFA Rule with other regulatory regimes. For example, the Alternative Investment Fund Managers Directive, as implemented in the EEA and the UK ("AIFMD") already requires EEA and UK alternative investment fund managers ("AIFMs"), and non-EEA and non-UK AIFMs marketing funds into the EEA or the UK, to disclose to investors, and report to regulators, information on preferential treatment afforded to investors.[66] While there are some synergies between the AIFMD requirements and the Preferential Treatment Rule such that advisers subject to both may be able to leverage their AIFMD disclosures to satisfy parts of the Preferential Treatment Rule, there is not complete overlap and advisers will need to conduct a thoughtful gap analysis.

While the future of the PFA Rule remains uncertain, the principles discussed in the rulemaking reflect the current SEC's focus on private fund advisers, and the SEC will likely continue to express these sentiments through its enforcement and examination initiatives. In an environment in which regulatory guidance from the SEC staff is scarce, the industry looks to the agency's enforcement activity to inform legal interpretations on open issues and guide compliance efforts. ■

[65] Adopting Release, *supra* note 3, at 304-5 (regarding the different compliance dates based on the size of private fund assets).

[66] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 Text with EEA relevance.

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