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Split SEC Overhauls Rules Governing Private Funds

By **Tom Zanki**

Law360 (August 23, 2023, 2:56 PM EDT) -- A divided U.S. Securities and Exchange Commission on Wednesday approved vast new rules increasing oversight over private-equity and hedge funds — albeit through a softer approach than originally proposed — drawing opposition from dissenters who fear the regulator is exceeding its authority.

By a 3-2 vote on party lines, the SEC's Democratic majority agreed to amend Investment Advisers Act of 1940 rules by requiring that private fund advisers provide their investors detailed disclosures regarding performances and fees, among other measures aimed at bolstering transparency and mitigating conflicts within a private funds industry estimated to manage $26.6 trillion in assets. Regulators will also require that such funds disclose when certain investors are granted preferential terms.

"We advance today's rules on behalf of all investors — big or small, institutional or retail, sophisticated or not," SEC Chair Gary Gensler said.

Yet several elements of the final rules were pared back from the agency's initial proposal in February 2022, which drew strong objections from private equity, real estate, venture capital and hedge funds who fear intrusion on private negotiations.

The SEC initially proposed to ban certain activities, including barring funds from charging investors to cover regulatory compliance expenses. Such actions will still be permitted so long as funds disclose such costs to investors or obtain their consent.

The changes reflect a shift in tone in the SEC's rulemaking. Lawyers note that various activities flatly prohibited in the proposal were described as "restricted" in the final rules.

"People going into this were bracing for the worst," said Eversheds Sutherland partner Issa Hanna, who represents investment advisers and funds. "What's come out is something quite short of the worst that people were concerned about."

Investment funds lawyers were still sorting through the 660-page rules document after its release on Wednesday, which they expect will be far reaching even if the final package is less drastic than originally designed.

"There were significant concessions made by the SEC from the proposed version, but the new rules will have a significant impact on the contractual and the business arrangements between private fund sponsors and investors," Morgan Lewis & Bockius LLP partner Christine Schleppegrell said.

Under the final rules approved Wednesday, fund advisers will have to provide quarterly statements disclosing to investors their performance, costs and other details. These funds will also be required to undergo annual audits and obtain a fairness opinion or valuation opinion before offering their investors an opportunity to sell their interests through certain secondary transactions.

Other activities the SEC initially sought to ban will be permitted if disclosed. For instance, the agency will allow advisers to pass the costs of government investigations or other regulatory and compliance issues onto investors if the expenses are disclosed.

However, funds must pay the costs of investigations that result in enforcement actions finding they have violated The Investment Advisers Act of 1940 or related rules.

The SEC's final rules also dialed back plans to regulate so-called side letters, which grant preferential terms to large investors. The SEC will prohibit fund advisers from granting investors preferential treatment regarding redemption rights and other information if regulators find that such treatment has a "material, negative effect" on other investors, subject to certain exceptions.

Otherwise, funds can continue to offer preferential terms so long as such conditions are disclosed to all investors. The SEC will also require that preferential terms that provide special redemption rights or access to increased information be offered to all investors.

Private funds have historically granted early stage or large investors preferential terms in order to increase their assets and bolster credibility with new investors in the process.

Separately, the SEC also dropped a prohibition on fund advisers' ability to charge fees for unperformed services because it believes such activity already violates an adviser's fiduciary duty obligations. The SEC also scrapped plans to prevent advisers from seeking indemnification from investors if they are found negligent in certain scenarios because much of that activity is already barred by fiduciary duty and anti-fraud laws.

Taken as a whole, the SEC majority argued that the new rules will shine light on a vast but opaque segment of the economy whose ripple effects spread beyond Wall Street.

Gensler noted that college endowments and pensions are deeply invested in private funds, which are often managed by hedge funds and private equity and venture capital firms. Those entities, in turn, often deploy that money into private companies.

The final rules, Gensler argued, will hold accountable intermediaries that stand between investors and companies, while improving competition and efficiency.

"That's good for investors," said Gensler, who was appointed by President Joe Biden and voted for the rules along with Democratic commissioners Caroline Crenshaw and Jaime Lizarraga. "That's good for issuers. It's good for markets alike."

Republicans Hester Peirce and Mark Uyeda opposed the measure, fearing the government was intruding into investments involving sophisticated parties, whom the SEC has long regarded as capable of fending for themselves without the protections afforded to smaller investors. Peirce argued that private markets would not have grown to their current size if investors were not being well compensated for their risks.

"As long as investors understand the terms on which they're investing, why should the government care what those terms are?" Peirce asked.

The SEC's actions are being watched closely by market participants.

Industry groups including the Managed Funds Association, which represents hedge funds, and the National Capital Venture Association said they are reviewing the final rules, concerned that SEC policies will hurt capital formation. The MFA, which previously raised concerns that the SEC is exceeding its statutory authority by intruding on private negotiations held between sophisticated parties, hasn't ruled out litigation.

"MFA will assess the final rule and work with our members to determine the appropriate next steps to protect the interests of alternative asset managers and their investors, including potential litigation," MFA President Bryan Corbett said in a statement

The progressive Americans For Financial Reform backed the SEC's plan, which it argues is within the agency's purview and is necessary to prevent funds from harvesting billions of dollars of fees at the expense of public pensions, retirees and other savers.

"The SEC has long exempted private funds from much disclosure required in public markets, so it is only logical that it has the power to improve transparency for investors," Andrew Park, senior policy analyst at Americans for Financial Reform Education Fund, said in a statement.

Simpson Thacher & Bartlett LLP partner David Blass expects the SEC's rule will invite litigation risks. Blass believes the SEC is basing its authority on Dodd-Frank Act provisions designed to regulate broker-dealer and investment adviser conduct when recommending investments to retail investors.

"Using that authority in the context of private funds is highly suspect to say the least," said Blass, who has served in senior roles in the SEC's investment management and trading and markets divisions.

The SEC's rules take effect once published in the Federal Register, with compliance dates ranging from six to 18 months after publication, depending on the provision.

--Editing by Alyssa Miller and Emily Kokoll.
