Finance Alert

September 2023

SEC's New Disclosure, Preferential Treatment Rules for Private Fund Advisers Challenged by Trade Groups

The Securities and Exchange Commission (SEC) recently adopted a series of new rules and rule amendments that will require private fund advisers to provide investors with more-detailed disclosures about their fees and to restrict preferential treatment for certain investors. Six trade groups promptly filed suit, alleging the scope of the new disclosure rules exceeds the SEC's authority.

The new rules, adopted on Aug. 23 under the Investment Advisers Act of 1940, are intended to protect investors who directly or indirectly invest in private funds by increasing transparency around compensation schemes, sales practices and conflicts of interest to prevent fraud, deception or manipulation by investment advisers. Specifically, the new rules require private funds investment advisers registered with the SEC to:

- Provide transparency to investors regarding the fees, expenses and other terms of their relationship with private fund advisers and the performance of such private funds.
- Obtain an annual financial statement audit of each private fund they advise.
- Obtain a fairness or valuation opinion from an independent opinion provider in connection with any adviser-led secondary transaction as well as disclose any material business relationships the adviser has with the independent opinion provider.

The new rules also prohibit all private fund advisers—including those not registered with the SEC—from:

- Engaging in certain activities such as charging or allocating to the private fund compliance, examination or investigation fees unless they provide specified disclosures.
- Borrowing or receiving an extension of credit from a private fund without disclosure to and consent from fund investors.
- Providing preferential treatment regarding redemptions from the private fund or information about portfolio holdings or exposures subject to certain exceptions as well as any other types of preferential treatment to any investor in a private fund unless the adviser satisfies certain disclosure obligations.

Private fund advisers have 12 to 18 months to comply with the new rules, depending on the rule and the size of the fund.

To avoid requiring advisers and investors to renegotiate governing agreements for existing funds, the SEC adopted legacy status provisions that apply to certain restricted activities and preferential treatment provisions. Legacy status also applies to governing agreements written before the compliance date and to funds that have commenced operations as of the compliance date.

Trade Groups Sue

Six private equity and hedge fund trade groups have already challenged the new rules and, on September 1,

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filed a petition for review in the U.S. Court of Appeals for the Fifth Circuit. The trade groups allege that in issuing the rules, the SEC exceeded its authority under the Investment Advisers Act and violated the Administrative Procedure Act. Joining the Managed Funds Association (MFA) on the petition are the National Association of Private Fund Managers, National Venture Capital Association, American Investment Council, Alternative Investment Management Association and Loan Syndications & Trading Association. Notably, SEC Commissioners Uyeda and Peirce issued dissents to the new rules, making arguments similar to those of the trade groups regarding the arbitrary and capricious nature of the rules. Commissioner Peirce called the rules "ahistorical, unjustified, impractical, confusing, and harmful."

The MFA said in a statement that the new rules will harm private fund advisers and their investors through increased fees, less competition and decreased choice for institutional investors, including pensions, foundations and endowments. In particular, the MFA argues that the new rules needlessly limit the right of private fund advisers and investors to tailor their relationships; enact overreaching restrictions on certain private fund adviser activities; and impose onerous, costly disclosure requirements and administrative obligations on private fund advisers that run counter to the SEC's stated mission to protect investors, facilitate capital formation, and maintain fair, orderly and efficient markets.

At this point in time, it is unclear whether the pending litigation will delay implementation of the rules.

Loeb & Loeb's Financial Services team is monitoring developments in the pending litigation and is here to discuss questions about the new rules and any potential concerns.

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