CARLTON FIELDS

SEC Proposes Sea Change in Private Fund Regulation: Doing Indirectly What It Could Not Do Directly?

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On February 9, 2022, a short-handed SEC voted, 3–1, to propose new rules and amendments under the Investment Advisers Act of 1940 “to enhance the regulation of private fund advisers and to protect private fund investors by increasing transparency, competition, and efficiency in the $18-trillion marketplace.”

Among other things, the proposal would require registered private fund advisers to:

- Provide investors standardized quarterly statements detailing private fund performance, fees, and expenses;
- Obtain an annual audit for each private fund and cause the private fund’s auditor to notify the SEC upon certain events; and
- Distribute a fairness opinion to investors in connection with an adviser-led secondary transaction, together with a written summary of material business relationships between the adviser and the opinion provider.

The proposal would also prohibit all private fund advisers, including those that are not registered, from:

- Engaging in certain activities and practices deemed contrary to the public interest and the protection of investors (such as seeking indemnification or exculpation from the adviser’s own negligence); and

- Providing certain preferential treatment to some investors that has a material negative effect on other investors, as well as certain other preferential treatment unless disclosed to current and prospective investors.

In addition, the proposal would require all registered advisers, including those that do not advise private funds, to document the annual review of their compliance policies and procedures in writing.

Some have interpreted the proposal as responding mainly to unions and public pensions, which have been unable to negotiate lower fees and additional disclosures to the extent they desire from private fund advisers. Until now, however, the underlying premise for allowing the practices of private funds to go largely unregulated has been that the sophisticated and well-heeled clientele of such funds are capable of fending for themselves. As such, they do not need the protections normally afforded retail investors under the federal securities laws.

The proposal turns this once bedrock premise on its head. Recognizing this, Commissioner Hester M. Peirce, the only vote against the proposal, issued a separate statement noting that the proposal "embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationships with private funds." She also noted that the proposal "affords retail-like protections to accredited investors" and threatens to divert enforcement resources away from protecting retail investors to protecting "millionaire investors from private fund advisers."

The extent of the SEC's authority to regulate private fund practices through its oversight of private fund advisers also seems questionable. In particular, the proposal relies heavily on the SEC's authority under Section 211(h) of the Advisers Act. This provision, as well as an identical provision under the Securities Exchange Act of 1934, was added as part of Section 913 of the Dodd-Frank Act of 2010. Section 913 mandated that the SEC conduct a study of the standards of care for broker-dealers and investment advisers with respect to the provision of personalized investment advice to retail investors and authorized the SEC to adopt rules addressing those standards "as necessary and appropriate in the public interest and for the protection of retail investors." Thus, Section 211(h) and its sister provision under the Exchange Act appear clearly to have been added by Congress only for the purpose of enabling the SEC, if it so determined, to harmonize or otherwise address gaps in the personalized retail advice standards of care between broker-dealers and investment advisers, and not for the purpose of enabling the SEC to regulate private fund practices writ large.

It is ironic to think that, rather than using Section 211(h) to regulate retail investment advice standards, as Congress seemingly intended, the SEC will use it, in effect, to regulate the business practices of private funds for the protection of investors least in need of regulatory protections. One wonders if Congress ever could have imagined the SEC using Section 211(h) as a cornerstone for such unprecedented regulatory changes. What will be the limits of the SEC's powers over private fund practices under Section 211(h)? And how do these newly claimed powers square with the exemption that private funds have from nearly all regulation under the Investment Company Act of 1940? At a minimum, they appear to blur the line drawn by Congress between regulated and unregulated funds, arguably without a clear congressional mandate.

What becomes of the proposal remains to be seen. As Peirce said in her dissenting statement, the "proposal represents a sea change." If not an understatement, that much is certainly true.

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