IV. Consequences of the 2023 SEC Private Fund Rules

A. Introduction

On August 23, 2023, the SEC issued new rules for the private fund industry. In his statement announcing the decision, Chair Gensler explained that the regulations were necessary to enhance "transparency and integrity," and "promote greater competition and thereby efficiency in this important part of the markets."[1] The Rules prohibit some practices, but they are mostly aimed at forcing advisers to disclose information that was previously hidden from many investors. Critics charge that these rules destroy value by improperly impinging on advisers' and investors' freedom to negotiate,[2] while supporters counter that they will level bargaining asymmetries.[3]

This article will begin by describing the private funds space, its recent history, and the regulatory treatment of private funds prior to the issuance of the August 23, 2023 Rules. It will then detail some of the arguments for and against the adoption of the new Rules. The article will then describe the new rules and conclude by examining some of their likely consequences.

B. Background: The Growth and Regulation of Private Funds

1. Private Funds

A private fund is an investment vehicle, generally structured as a limited partnership, where an adviser invests money on behalf of investors.[4] The most common types of private funds are hedge funds, private equity funds, and venture capital funds. Hedge funds typically

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[1] Statement, Gary Gensler, Chair, SEC, Statement on Private Fund Advisers (Aug. 23, 2023), https://www.sec.gov/news/statement/gensler-statement-private-fund-advisers-082323.

[2] Statement, Hester M. Peirce, Commissioner, SEC, Uprooted: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Aug. 23, 2023), https://www.sec.gov/news/statement/peirce-statement-doc-registered-investment-adviser-compliance-reviews-08232023.

[3] Gensler, *supra* note 1.

[4] *Private Fund*, SEC.GOV (modified Aug. 23, 2023), https://www.sec.gov/education/capitalraising/building-blocks/private-fund.

invest in publicly traded equities and notes using proprietary strategies.[5] Private equity funds typically purchase ownership of companies.[6] They actively manage the companies they own and earn returns by collecting a portion of their revenue and by selling their stakes for a profit.[7] Venture capital funds invest in early-stage companies, providing founders with the capital necessary to grow their businesses and the expertise to manage them.[8] Private fund advisers typically earn income by charging fees to investors, collecting revenue directly from the companies they manage, and investing their own equity into the funds they advise.[9]

2. Growth Since 2000

The private funds industry emerged in response to the New Deal regulatory regime.[10] That regime distinguished between funds which could accept investments from the general public, which were heavily regulated, and funds which were prohibited from accepting money from ordinary investors but who consequently were exempt from many regulations.[11]

Since 2000, the proportion of assets invested in private funds has grown steadily, and private fund allocations have grown four times faster than the U.S. economy.[12] As of Q4 2022, there were $19,908,000,000 invested in 43,745 private funds managed by 3,669

[5] Lisa Lilliott Rydin, *Private Equity, Venture Capital, and Hedge Funds*, HARV. L. SCH. LIBR. (modified Oct. 2, 2023), https://guides.library.harvard.edu/law/private_equity.
[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] CFI Team, *2 and 20 (Hedge Fund Fees)*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/career-map/sell-side/capital-markets/2-and-20-hedge-fund-fees/, (last visited Nov. 11, 2023).
[10] Wulf A. Kaal, *Private Investment Fund Regulation – Theory and Empirical Evidence From 1998 to 2016*, U. PENN. J. OF BUS. L. 579, 583 (2018).
[11] *Id.*
[12] Statement, Caroline A. Crenshaw, Commissioner, SEC, Statement Regarding Private Fund Advisers Rulemaking (Aug. 23, 2023), https://www.sec.gov/news/statement/crenshaw-statement-private-fund-advisers-082323.

advisers in the United States.[13] Significantly, 25% of the assets managed by private funds now come from institutional investors who manage investments for persons who would otherwise be prohibited.[14]

3. *The Advantages of Private Funds*

Private funds claim they can deliver higher returns than those available in public markets due to their advisers' managerial skills and the illiquidity premiums offered in private markets.[15] This conclusion is contested, but research generally supports the finding that private funds deliver marginally higher returns.[16] Investors are also attracted by the diversification and stable valuations that private investments offer.[17] Private funds invest in asset classes which are unavailable on the stock market and whose returns are often uncorrelated to its movements.[18] Diversification protects an investor's overall portfolio when one part of the market suffers a downturn.[19] Private markets are illiquid, prices are only updated when a sale occurs, and sales are often rare.[20] Because of this, investors will not always have to report a loss on their investments when they suffer a decline. This is especially attractive to investors who

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[13] U.S. SEC DIV. OF INV. MGMT. ANALYTICS OFF., PRIVATE FUNDS STATISTICS THIRD CALENDAR QUARTER 2022 (2023), https://www.sec.gov/files/investment/private-funds-statistics-2022-q3.pdf.

[14] *Id.*

[15] John Plender, *Private Equity Faces a Reckoning*, FIN. TIMES (Nov. 11, 2023), https://www.ft.com/content/b27e7a59-d319-4f84-bf4a-a3659efd725.

[16] Michael Cembalest, *Food Fight: An update on private equity performance vs public equity markets*, JP MORGAN ASSET AND WEALTH MGMT. EYE ON THE MARKET, at 2 (Jun. 28, 2021), (finding that private equity outperformed the S&P 500 by about 1.05% on average annually, but that this outperformance may be eaten up by fees).

[17] Ohio Pub. Emp. Ret. Sys., Comment Letter on Private Fund Advisers: Documentation of Registered Investment Adviser Compliance Reviews (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126471-287115.pdf.

[18] Angela Sormani, *An Analysis of US-Based Public Pension Fund Allocations to Private Equity*, PREQIN (June 11, 2015), https://www.preqin.com/blog/0/11528/us-public-pensionfunds.

[19] *Id.*

[20] Matt Levine, *Matt Levine's Money Stuff: Private Markets Don't Like to Go Down*, BLOOMBERG, (Jan. 4, 2023), https://www.bloomberglaw.com/bloomberglawnews/mergers-andacquisitions/XFIN4FCG000000?bna_news_filter=mergers-and-acquisitions#jcite.

are required to maintain a certain value of assets in their portfolios, such as pension funds.[21]

The growth of private markets has impacted the lifecycle of public companies. The increasing size of private funds has allowed advisers to use the carrot of attractive terms and the stick of forced buyouts to increase their holdings.[22] As a result, early-stage companies tend to stay private for longer, and public companies are more likely to be taken private today than they were before the explosive growth of private funds.[23]

4. The Previous Regulatory Regime

When they first began to appear in the 1950's, private funds were not required to register with the SEC and were exempt from most securities regulations,[24] with the exception of Regulation D Rule 501,[25] which prohibits them from taking money from non-Qualified Investors.[26] Qualified Investors are defined as persons "having (1) annual income exceeding either \$200,000 (singly) or \$300,000 (with spouse or spousal equivalent) in each of the two most recent years; (2) more than \$1 million in net worth, excluding the primary residence (singly or with spouse or spousal equivalent); or (3) certain financial professional credentials."[27] This persisted until the 2008 Financial Crisis,[28] when Dodd-Frank finally imposed more significant regulations on the private funds industry. Dodd-Frank required advisers to register with the SEC and to regularly disclose the net asset values of their funds,

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[21] *Id.*
[22] Michael Ewans, *The Evolution of the Private Equity Market and the Decline in IPOs*, HARV. L. SCH. F. ON CORP. GOV. (Sept. 28, 2017), https://corpgov.law.harvard.edu/2017/09/28/the-evolution-of-the-private-equity-market-and-the-decline-in-ipos/.
[23] *Id.*
[24] Wulf, *supra* note 10, at 583.
[25] 17 CFR § 230.501 (2011).
[26] *See* SEC.gov, *supra* note 4.
[27] *Cutting Through the Jargon From A to Z*, SEC.GOV (modified Sept. 5, 2023), https://www.sec.gov/education/glossary/jargon-z#Fund3C7.
[28] The failure of Long Term Capital Management in 1998 led to calls for regulation which were answered by a set of regulations issued by the SEC in 2004. However, these rules were struck down by the D.C. Circuit the next year. *See* Wulf, *supra* note 10, at 586-89.

the liquidity of their assets, and any restrictions on investor withdrawals.[29]

Advisers and investors were otherwise free to negotiate bespoke terms, and advisers were mostly allowed to grant different material terms to investors in the same fund.[30] Advisers commonly grant preferential terms to attract investors into new funds, entice larger capital commitments, cultivate relationships with important investors, or accommodate investors like pension funds who are subject to special liquidity or reporting requirements.[31] Preferential terms commonly include customized investing strategies, special monitoring and control rights, reduced fees and expenses, access to special investment opportunities and more experienced management personnel, and customized reports.[32] Investors also commonly agree to indemnify advisers for cost of contesting regulatory enforcement actions.[33] While not every preferential term results in harm to other investors, terms that raise the costs or lower the returns of other investors in the same fund, such as preferential fees, withdrawal rights, or opportunity allocations decrease total welfare.[34]

5. *New Regulation: Arguments For and Against*

The growth of this sector led to concern that the previous regulatory framework was inadequate.[35] While it may have been suited to a world where private investments were negotiated between advisers and wealthy, sophisticated investors, ordinary investors are now heavily exposed to these investments via pension and retirement funds.[36] Increasing competition for investment opportunities has given more leverage to advisers, allowing them to exploit power and information

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[29] *Id.* at 591 n.61.

[30] William Clayton, Comment Letter on Private Fund Advisers: Documentation of Registered Investment Adviser Compliance Reviews, at 182 (Apr. 21, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20125350-284820.pdf.

[31] William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, VA. L. & BUS. REV., 249, 266 (2017).

[32] *Id.*

[33] Alt. Inv. Mgmt. Ass'n., Comment Letter on Private Fund Advisers: Documentation of Registered Investment Adviser Compliance Reviews, at 21 (Apr. 25, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20126739-287453.pdf.

[34] Clayton, *supra* note 31, at 283.

[35] Gensler, *supra* note 1.

[36] *Id.*

asymmetries.[37] The new Rules are necessary to level this playing field and prevent advisers from forcing inequitable terms on unwary investors.[38]

Opponents of reform argue that there are no obvious issues with the status quo. Private funds are still limited to accepting investments from sophisticated actors.[39] When ordinary people's money is invested in private funds, it is deployed through institutional investors who have the expertise to make informed decisions and the leverage to negotiate on equal terms with advisers.[40] Further regulations will prevent investors from negotiating terms to suit their needs.[41] Opponents contend that additional reporting requirements will increase the amount of money that advisers must spend on compliance.[42] These costs will be passed along to investors in the form of higher fees.[43] New compliance procedures will also favor incumbent advisers who can distribute these increased burdens more efficiently.[44] As a result, fewer new advisers will enter the space, decreasing competition and overall efficiency.[45] In addition, they claim that SEC regulations are often vague, and it can be difficult for advisers to avoid falling afoul of them.[46] Advisers and investors see these penalties as a cost of doing business, and many investors are happy to indemnify their advisers to incentivize them to take risks that generate higher returns.[47] In sum, opponents of regulation argue that the space is hardly the Wild West today, and that flexibility allows advisers and investors to customize terms to suit their needs.[48]

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[37] *Id*.
[38] *Id.*
[39] Alt. Inv. Mgmt. Ass'n., *supra* note 33, at 2.
[40] *Id*.
[41] *Id*.
[42] *Id*.
[43] *Id*. at 17 ("New funds are likely to have higher fees in order to account for certain costs that are unquantifiable ex ante (such as costs for regulatory examinations and compliance fees). While their investors will be made aware of the higher fees, such investors may respond in turn by allocating their capital away from new advisers and funds.").
[44] *Id*.
[45] *Id*.
[46] *Id.* at 32.
[47] *See* Alt. Inv. Mgmt. Ass'n, *supra* note 33, at 2.
[48] *See* Peirce, *supra* note 2.

C. The Final Rules and Their Impact

The following section summarizes the 2023 Rules and indicates some of their likely consequences for the private funds industry.

1. The Preferential Treatment Rule

The Preferential Treatment Rule[49] limits the kinds of preferential rights that an adviser may grant to investors.[50] It focuses on three species of preferential terms: (a) redemption rights; (b) material information; and (c) preferential rights.[51]

(a) Redemption Right

The Rule prohibits advisers from granting any investor the right to redeem their investment in a fund or "substantially similar pool of assets" on terms that the adviser reasonably expects will have a material negative impact on other investors.[52] The only exceptions are where: 1) the adviser has offered and will continue to offer the same term to all investors in the fund, regardless of their identity or the size and length of their commitment; or 2) where an investor is prohibited by law or regulation from accepting the fund's default redemption terms.[53] Significantly, this rule applies to funds and "substantially similar pools of assets."[54] Therefore, advisers cannot carve out nominally separate investment vehicles which invest in the same set of assets as the main fund but offer different terms.[55]

This rule could lead to the total elimination or drastic curtailment of the practice of offering preferential redemption rights.[56] Depending on how the Rule is interpreted, it could also prevent advisers from offering parallel closed and open-ended funds.[57] Finally, although

[49] 17 CFR § 275.211(h)(2)-3 (2023).
[50] T.J. Bright et al., *The SEC's New Private Fund Adviser Rules: A Guide to Compliance*, K&L GATES 11 (2023) https://files.klgates.com/webfiles/The_SECs_New_Private_Fund_Adviser_Rules_A_Guide_To_Compliance.pdf.
[51] *Id*.
[52] *Id*. at 12.
[53] *Id*.
[54] *Id.* at 11-12.
[55] *Id*. at 12.
[56] *Id*.
[57] *Id.* at 11-12.

the second exception would allow ERISA-regulated investors to negotiate for preferential redemption rights, advisers often offer ERISA terms to certain ERISA-exempt non-profits, and these rules could eliminate this practice.[58]

(b) Material Information

The Rule also prohibits an adviser from offering any investor information about a fund that it reasonably believes will have a material negative impact on other investors unless it provides such information to all investors simultaneously.[59] It primarily aims to prevent advisers from giving certain investors advance information that might cause them to exercise their withdrawal rights.[60] Therefore it will primarily be interpreted to apply to liquid, open-ended funds.[61]

This rule may discourage advisers from offering bespoke reports.[62] This could be particularly problematic for investors who have mandatory reporting requirements related to adviser fees or ESG factors.[63] This rule may also create compliance issues for investors who invest in multiple funds managed by the same adviser, as information related to one fund may be deemed to have a material impact on the adviser's other funds.[64]

(c) Preferential Rights

Finally, the Rule[65] mandates that when an adviser provides material preferential terms to any investor, they must provide all other investors in that fund with written notice.[66] This disclosure must be provided as soon as the investor receiving the term makes their investment in the fund, and all investors must receive annual notice of all preferential terms granted to other investors in the fund.[67] Because of this, negotiations for the launch of new funds are likely to become

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[58] *Id*. at 12.
[59] 17 CFR § 275.211(h)(2)-3(a)(2)).
[60] Bright, *supra* note 50, at 13.
[61] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, SEC Release No. IA-6368 281 (Aug. 23, 2023).
[62] Bright, *supra* note 50, at 15.
[63] Alt. Inv. Mgmt. Ass'n, *supra* note 33, at 49.
[64] Bright, *supra* note 50, at 15.
[65] 17 CFR § 275.211 (h)(2)-3(b)) (2023).
[66] Bright, *supra* note 50, at 15.
[67] *Id*.

significantly more complicated. Advisers commonly negotiate with multiple investors simultaneously, and investors may seek to renegotiate investment terms in light of a disclosure.[68]

2. *The Restricted Activities Rule*

This Rule[69] prohibits advisers from charging investors for expenses associated with compliance or a government investigation, unless the adviser provides written notice of the charge within forty-five days of the end of the fiscal quarter in which the expense is charged.[70] It prohibits an adviser from charging investors for fund expenses on a non-pro rata basis unless the adviser first distributes written notice to all investors disclosing the charge and explaining why it is fair and equitable.[71] It prohibits the adviser from borrowing money or other assets from an investor in a fund unless the adviser first discloses the loan and obtains written consent from a majority of the other investors.[72]

This Rule will likely lead advisers to begin charging higher fees to compensate for the cost of enforcement actions which investors previously indemnified them for.[73] This may place smaller advisers at a disadvantage, as advisers with in-house resources to fight these actions will likely have to raise their fees by less than their smaller competitors.[74] The Rule will also likely cause advisers to update their fund documents going forward to provide for the required disclosures, but this may have limited impact on the actual operation of funds.[75]

3. *The Quarterly Statement Rule*

Under this Rule,[76] a Quarterly Statement must be delivered to investors in any fund within forty-five days of the end of the first three annual fiscal quarters and within ninety days of the end of the final

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[68] *Id*.
[69] 17 CFR § 275.211(h)(2)-1(a)(2)).
[70] Issa J. Hanna Et Al., *SEC Adopts Sweeping New Private Fund Adviser Rules*, EVERSHEDS SUTHERLAND, (Oct. 2, 2023), https://www.corporatecompplianceinsights.com/sec-private-fund-adviser-rules/.
[71] *Id*.
[72] *Id*.
[73] Bright, *supra* note 50, at 19-24.
[74] *Id*.
[75] *Id*.
[76] 17 CFR § 275.211(h)(1)-2 (2023).

quarter.[77] Each statement must include: 1) a detailed accounting of all compensation paid to the adviser during the period, calculated at the adviser level; 2) a similar accounting, calculated at the fund level; 3) for liquid funds, performance information disclosing annual net total return over the past ten years, average annual net returns for the past one, five, and ten year periods, and cumulative net total returns for the current fiscal year; 4) for illiquid funds, performance information disclosing the fund's gross and net internal rate of return and multiple on invested capital, the same metrics for the realized and unrealized portions of the fund's portfolio, and a statement of contributions and distributions; and 5) disclosures of the manner in which expenses, payments, allocations, and offsets were calculated.[78] The Rule also specifies how this information must be presented.[79] Additionally, in reporting the value of their investment portfolios, advisers must look to public-market equivalents rather than relying on internal models to determine the value of their private assets.[80]

This Rule will require funds to make broader and more frequent disclosures than they typically have, and it will require them to update their forms to comply with the new presentation requirements.[81] These disclosures will improve investors' ability to compare advisers' results.[82] However, requiring the use of public-market equivalents could produce distorted reports where advisers manage assets which do not have a publicly traded equivalent.[83]

4. The Private Fund Audit Rule

This Rule[84] requires advisers to obtain an annual independent financial audit of each of their funds, and to distribute the results to investors within 120 days of the end of each fiscal year.[85] The impact of this Rule is likely to be limited. Most advisers already obtain and distribute annual audits.[86] However, it is unclear how many funds

[77] Bright, *supra* note 50, at 25-28.
[78] *Id*.
[79] *Id*.
[80] Alt. Inv. Mgmt. Ass'n, *supra* note 33, at 57.
[81] Bright, *supra* note 50, at 25-28.
[82] *Id*.
[83] Alt. Inv. Mgmt. Ass'n, *supra* note 33, at 57.
[84] 17 CFR § 275.06(4)-10).
[85] Bright, *supra* note 50, at 29-30.
[86] *Id*.

currently do not obtain such audits, and there may not be enough registered auditing firms to handle the increased demand created by this Rule.[87]

5. The Adviser-Led Secondary Rule

An adviser-led secondary transaction is any transaction initiated by the adviser that offers investors the option to either sell their interest in the fund to another party or convert their interest in the fund into an interest in another fund.[88] This Rule [89] requires that, before initiating a secondary transaction, advisers must obtain an opinion from an outside source explaining why the price being offered is fair and distribute the opinion to investors along with a written summary of any material business relationships the adviser has had with the source of the opinion during the prior two years.[90]

The impact of this Rule is likely to be limited because it is currently standard practice for private fund advisers to obtain a fairness opinion for most secondary transactions.[91] However, advisers often forgo obtaining opinions for transactions below a certain dollar amount, so the requirement might deter these smaller transactions.[92]

D. Conclusion: Some Possible Future Developments

The final impact of the Rules will be worked out over the next few years as the industry adopts new practices and regulators clarify their scope. However, several broad trends can be predicted.

1. Increased Standardization

Pressure from regulators and investors will likely erode many idiosyncratic practices across funds and produce more standardization of terms and procedures. The rules governing the presentation of reporting practices may produce standardized disclosure forms, like the ones issued by publicly traded companies and funds.[93] Similarly, the

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[87] *Id*.
[88] Hanna, *supra* note 70.
[89] 17 CFR § 275.211 (h)(2)-2.
[90] Hanna, *supra* note 70.
[91] Bright, *supra* note 50, at 30-32.
[92] *Id*.
[93] *Id.* at 25-28.

limits placed on bespoke reports by the Preferential Treatment Rule means that, from now on, advisers will likely provide one set of disclosures to all fund investors.[94] These rules are also likely to drive a convergence of adviser valuation practices.[95] They will certainly not eliminate advisers' ability to manipulate their reporting to present returns in the most flattering possible light, but the reporting requirements of the Quarterly Statement and Audit Rule will make these manipulations more transparent.[96] The limits on preferential treatment will also likely increase the use of "off-the-rack" rather than bespoke terms. The disclosure requirements will make simultaneous negotiations in which each party receives custom terms difficult.[97] Further, if each investor knows the terms that other investors are receiving, they will likely attempt to negotiate similar terms for themselves, resulting in a roughly standard set for each fund.[98] Over time, funds will likely offer a standard set of terms rather than engaging in individual negotiations.

2. *Increased Consolidation*

These Rules will increase the cost of compliance for all funds, and these costs will fall hardest on smaller funds who have less ability to absorb and spread them.[99] The SEC estimates that complying with these rules will cost advisers at least $1,800,000,000 annually.[100] These costs will likely be passed along to investors in the form of higher fees, but it is not clear whether the overall cost to investors will be greater, since many of these expenses were already being passed along on an ad hoc basis.[101] However, not all advisers will be equally capable of passing these costs along. Smaller and less-established advisers will likely be forced to internalize more of these costs than their larger competitors.[102] Many of the costs imposed by these rules will decrease proportionately with the size of a fund. Larger funds will be able to offer

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[94] Alt. Inv. Mgmt. Ass'n, *supra* note 33, at 49.
[95] *Id.* at 57.
[96] 17 CFR § 275.211(h)(1)-2 (2023).
[97] Bright, *supra* note 50, at 15.
[98] *Id.* at 39.
[99] Alt. Inv. Mgmt. Ass'n, *supra* note 33, at 17.
[100] Brooke Masters, *Private funds prepare to spend billions on compliance after SEC rule*, FIN. TIMES, (Sept. 14, 2023), https://www.ft.com /content/6d39f967-e141-418c-aef0-76bb337c64ba.
[101] Alt. Inv. Mgmt. Ass'n, *supra* note 33, at 33.
[102] *Id*. at 34.

lower fee products to investors, undercutting competition.[103] The Rules will raise the cost of launching new funds, and they prohibit or complicate practices that advisers have traditionally used to attract investors to these ventures.[104] As a result, these rules will create a greater incumbency advantage, and the industry is likely to become more consolidated.

3. Increased Transparency

Investors will enjoy more transparency into the funds they invest in because of these rules. The disclosure requirements will make it easier for investors to compare the performance of advisers, and the Preferential Treatment Rules will give them a better sense of the terms that other investors are receiving.[105] This will allow investors to make more intelligent and informed decisions when allocating capital. Mandatory disclosure, and, in some cases, consent, will also increase investors' negotiating power.[106] They will likely be able to use this increased leverage to get better terms from advisers, and large, well-connected investors will no longer be able to negotiate for terms that materially harm less powerful investors.[107] As investor protections become more standardized and the industry becomes "safer," they may even lead to calls to open the private funds industry to a broader swathe of the investing public.

Henry Colocotronis[108]

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[103] *Id*.
[104] Clayton, *supra* note 31.
[105] Bright, *supra* note 50, at 25-28.
[106] *Id*. at 17.
[107] *Id*. at 19.
[108] Student, Boston University School of Law (J.D. 2025).