Press Kit for Private Fund Advisers Rules

- On August 23, the Securities and Exchange Commission—over multiple dissents—adopted a series of sweeping rules that fundamentally alter the longstanding, widely used business arrangements of private funds. Private funds are a major driver of economic growth, investing in thousands of businesses, with millions of employees, and returning, over the years, trillions of dollars in gains to investors. The Commission's attempt to restructure the business arrangements of private funds is unlawful, unwarranted, and ultimately harmful to investors. Private fund investors are among the largest and most sophisticated in the world, and Congress has long recognized that they do not require the type of exhaustive regulatory requirements the Commission is now imposing. For good reason: The Commission's rules would curb the entrepreneurialism, flexibility, and investment returns that make private funds an increasingly attractive option for the world's most sophisticated investors.

- In imposing these new requirements, which are further summarized below, the SEC has exceeded its statutory authority and violated the requirements for agency rulemaking in multiple ways.

    - The Commission does not have the authority to subject private funds to these prescriptive regulations, which are the type of intrusive requirements from which Congress expressly exempted private funds and their advisers.

    - In any event, the Commission has not shown any need for the onerous rules it has adopted, and has made no attempt to justify their exorbitant cost—cost that will be borne by the very investors the Commission claims to protect. The courts have frequently struck down SEC rules for similar errors in the agency's economic analysis. *See*, *e.g.*, *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010); *Chamber of Com. of U.S. v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005).

    - While the final rules purport to water down the most extreme parts of the proposed rules by adding disclosure and consent exceptions, the Commission never subjected those exceptions to public comment, and they act as de facto bans on the targeted practices due to their overall unworkability.

- Accordingly, a broad and unprecedented coalition of business groups has filed suit in the U.S. Court of Appeals for the Fifth Circuit, asking the Court to set aside the rules as exceeding the agency's statutory authority and as arbitrary, capricious, and otherwise unlawful.

ADDITIONAL BACKGROUND

The Contributions of Private Funds

- Private funds—whether they take the form of venture capital, private equity, private credit, or hedge funds—make critical contributions to the strength of the American economy.

    - **Venture capital funds** are a transformative force in our nation's economy. Venture capitalists partner with institutional investors, combining the capital held by those investors with the talent and expertise of the venture-capital adviser to make much-needed, long-term investments in the nation's innovative young companies. Venture capital drives economic growth, spurring job creation, innovation, and new business models that transform the world. In 2022 alone, venture capital funds invested more than $240 billion in over 15,000 U.S. companies; furthermore, venture-backed companies create jobs at eight times the rate of other businesses.

    - **Private equity** is another major driver of economic growth. Many businesses struggle to obtain affordable capital; they turn to private equity. Private equity firms provide much-needed capital to mature and growth-stage businesses, while offering valuable expertise that bolsters performance to boot. Today, 5,000 private equity firms back 18,000 companies, employing 12 million people. The arrangement is a proven success. Over the last 20 years, private equity has consistently outperformed public markets, and from 2005 to mid-2021, private equity distributed *more than $2.7 trillion* to investors.

    - **Hedge funds** likewise play a critical role in America's investment landscape. They allocate trillions of dollars in investment capital, while effectively and efficiently managing investment risk. With a market-neutral or balanced approach to investing, hedge funds offer investors positive returns, over various time horizons, with better protection from market volatility and downturns than other investment benchmarks. Investors are highly satisfied with their hedge fund allocations—80% believe that their portfolio risk would *increase* without hedge funds.

    - **Private credit** is a key source of financing for American companies of all sizes across the business cycle. Private credit funds provide financing to companies directly, stepping in when banks cannot or will not lend. The debt is typically underwritten by individual funds or a small group of funds, creating a manageable lender base for issuers and attractive loans with credit enhancements for lenders. Fueled by companies' need for simple and accessible financing, private credit has grown rapidly. Affected private credit funds provide hundreds of billions of dollars of credit to American companies—and their ability to continue such financing will be called into question under these rules.

Investors in Private Funds

- The retail investors who are at the heart of the SEC's mandate do not invest in private funds. Instead, by law, private fund investment is limited to wealthier and typically more experienced investors—the investors covered by the new Commission rule are among the most sophisticated in the world, including some of the world's largest pension funds, banks, and sovereign wealth funds. In making their investments in venture capital, private equity, and hedge funds, these investors are represented by sophisticated counsel from some of the nation's leading law firms, who specialize in representing clients making precisely these sorts of investments. (For a list of some of the leading investors in private equity funds, for example, see Exhibit A.) In adopting its new rules, the Commission is prioritizing these investors over actions to benefit retail and Main Street American investors.

Flaws in the SEC's new PFA Rules

- **Side Letter Rights Rule**

    - Private fund advisers and the sophisticated investors who invest in private funds have, over the years, developed longstanding, widely used business practices that yield important benefits for both parties. For example, one commonly negotiated private-fund arrangement is side letter rights. The sophisticated investors who invest in private funds often request bespoke contractual terms to address their specific needs, including to satisfy certain state and local regulations that may apply only to one or a few investors (e.g., to certain pension funds). Because those needs are particular to each individual investor and separate from the fund's broad operating principles, the standard practice is to address those concerns through side letters with each investor, rather than change the terms for *all* investors.

    - The Side Letter Rights Rule would effectively bar many of these common arrangements. In adopting the final rule, the Commission acknowledged commenters' concerns that the proposed rule would cause serious problem—such as curtailing investors' ability to enter into side letters—so it modified its proposal to adopt so-called "exceptions." But some of those exceptions are no exceptions at all. For example, the Commission purports to allow "preferential" redemption and information rights where the adviser offers the "same" rights to "all" investors. As Commissioner Peirce aptly noted in dissent, "Conditioning preferential rights on offering them to everyone sounds like a ban on offering preferential rights, but the release does not characterize what we are doing as a ban."

    - As the Commission recognized, impeding the use of side letters carries serious repercussions for private fund investors. Side letters not only allow private funds to accommodate the specific needs or concerns of individual investors; they facilitate the recruitment of anchor investors, a process that will now be more difficult, hampering the ability of new funds to enter the market. The Commission's de facto ban will also impose needless burden and expense, as advisers will need to determine in every instance whether what until today have been standard contractual terms are prohibited by a vague and broadly worded standard—costs that will fall on fund investors as a whole.

- **Restricted Activities Rule**

  - Private fund agreements often contain other closely negotiated arrangements as well. Private fund agreements, for example, often allow advisers to charge funds fees for examinations, investigations, and other regulatory costs, a common arrangement that reduces costs (e.g., insurance costs) and properly incentivizes the adviser (e.g., to invest in compliance).

  - The Restricted Activities Rule would upend these (and other) arrangements, which have been worked out over many years by highly sophisticated parties who find the arrangements mutually beneficial. While the Commission created exceptions that purportedly allow for the charging of fees or expenses associated with examinations, investigations, or compliance matters, these exceptions are unworkable in practice.

  - Effectively banning these common fund terms would harm the very investors the rule is intended to protect by increasing up-front costs and discouraging investment in compliance.

- **Quarterly Reporting Rule**

  - The sophisticated investors who invest in private funds have long had access to ample information about the terms of their investments. As the SEC previously acknowledged, private fund advisers *already* "provide fee, expense, and performance reporting to investors." Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,886, 16,890–91 (proposed Mar. 24, 2022).

  - The Quarterly Reporting Rule imposes prescriptive, unnecessary, and burdensome new reporting requirements, compelling advisers to prepare costly quarterly statements that investors do not need. Private fund investors already negotiate for their desired disclosures. The rigid reporting system the rule contemplates will only impose additional administrative burdens and costs. And those costs will fall most heavily on new and emerging managers, forcing them to expend resources on complying with the new reporting requirements rather than developing their business.

Petitioners' Claims

The coalition anticipates advancing the following principal arguments, reflected in existing comment letters, in the suit filed today challenging the new SEC rules:

- The rules exceed the authority granted to the Commission by Congress. The Commission claims to have found a sweeping power to regulate private fund advisers in a section of the Dodd-Frank Act concerning ***retail*** customers—a section that does not mention private funds. The Commission's asserted power does not exist. Indeed, if Congress had really intended to authorize the Commission to exercise significant regulatory authority over private funds, Congress would have mentioned that power in Title IV of Dodd-Frank, which concerns private fund advisers, not buried it in a paragraph on "[o]ther [m]atters" in a section about retail customers.

  - Congress carefully delineated between registered investment companies (such as mutual funds) and private funds. Registered investment companies—serving ordinary retail investors—are governed by the Investment Company Act, which sets forth detailed rules governing almost every aspect of investment companies' operations. *See* 15 U.S.C. §§ 80a–1 to –64. Congress deliberately chose to exempt private funds from this intrusive regime, *see id.* § 80a–3(c)(1), (c)(7), in recognition of the fact that most investors in private funds are presumed to be "in a position to appreciate the risks associated" with their investments. Prohibition of Fraud By Advisers to Certain Pooled Investment Vehicles, Securities Act Release No. 8766, 2006 WL 3814994, at *9 n.45 (Dec. 27, 2006). The newly adopted rules run roughshod over that determination by effectively taking common private fund features off the table and mandating costly new reporting requirements that serve no useful purpose.

  - The Commission asserts that it has authority to adopt the final rules under sections 211(h) and 206 of the Advisers Act, but neither provision supports the agency's actions.

  - Section 211(h) is a clean-up provision tacked on to a section of the Dodd-Frank Act addressing the provision of advice to ***retail*** customers. Congress "does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions," *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468 (2001), yet the Commission asserts that section 211(h)—which does not mention private funds—is actually a broad grant of authority over private funds and their advisers. Furthermore, section 211(h) is inapt for other reasons as well. While the Commission relies on section 211(h)(2) as authority for most of the final rules, that provision concerns the promotional methods employed by broker-dealers and investment advisers in interacting with retail customers, not the terms of an agreement.

  - As authority for the final rules, the Commission also invokes section 206(4), which grants it authority to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 80b–6(4). But here the Commission failed to "define" the allegedly fraudulent acts, and failed to explain how the final rules would prevent those (undefined) acts. Nor are the sweeping de facto prohibitions adopted by the Commission "reasonably designed" to prevent fraud.

- Many of the provisions are unnecessary and unduly burdensome.

  - Under the Administrative Procedure Act, an agency adopting a new rule is required to "examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.' "

Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983). The SEC fell far short of those requirements here.

- For example, although the Commission acknowledged that the prohibition of side letter rights would harm investors, the Side Letter Rights Rule functions as a de facto ban. This basic problem reveals that the Commission has fundamentally misunderstood the practices and issues it now purports to regulate and so has "entirely failed to consider an important aspect of the problem." *State Farm*, 463 U.S. at 43.

- As another example, the Restricted Activities Rule prohibits advisers from charging regulatory, compliance, and examination expenses to the fund unless they distribute written notice of such fees or expenses to investors on a quarterly basis. Once again the Commission recognized that an outright ban would harm investors—in this instance, by disincentivizing compliance. Yet it adopted an exception that is unworkable because the highly granular reporting it requires will be cumbersome and infeasible in practice.

- Similarly, the Restricted Activities Rule prohibits advisers from charging fees or expenses associated with an investigation by a governmental entity to the fund unless the adviser obtains written consent from a majority of its investors. The Commission again accepted that a ban on charging such fees would disadvantage investors, but the exception it adopted is illusory. Advisers may not even know they are under investigation and may be forced to guess whether they are in order to determine whether consent is required to charge related expenses. And advisers may be subject to confidential investigations and therefore required to disclose the confidential investigation and other confidential information to obtain consent.

- The SEC engaged in a flawed economic analysis.

  - In adopting rules, the SEC is also obligated to consider whether the rules "will promote efficiency, competition, and capital formation." 15 U.S.C. § 80b–2(c). Unless the SEC "apprise[s] itself—and hence the public and the Congress—of the economic consequences of a proposed regulation," the "promulgation of the rule [is] arbitrary and capricious and not in accordance with law." *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011). Numerous SEC rules have been invalidated for failing to meet this statutory requirement. *See*, *e.g.*, *id.*; *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010); *Chamber of Com. of U.S. v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005).

  - The Commission's economic analysis here is flawed for a number of reasons. The analysis is highly theoretical, often lacking concrete examples and real-life incidents; it omits key data and frequently relies on the unsubstantiated "observations," "understandings," and "experience" of SEC staff. For example, the Commission says projecting the benefits of the quarterly reporting requirement is "difficult" because of a lack of data and that "[e]ven if these data existed, it would be difficult to quantify how receiving such information . . . may change investor behavior." That amounts to a confession that the Commission does not know whether the rule will be beneficial at all.

- Additionally, the Commission's treatment of competition and capital formation is inadequate. The Commission asserts that the final rules will expand competition by creating opportunity for new or smaller advisers to compete with larger advisers. But the Commission simultaneously seeks to downplay the cost of the final rules by suggesting that smaller advisers may reduce their size to avoid various of the regulations. The Commission's assertion that the final rules will enhance competition is contradicted by its own predictions about the likely behavior of smaller advisers.

- Furthermore, although the "cumulative effect" of related rulemakings is an "important aspect of the problem," *Alliance for Hippocratic Med. v. FDA*, 2023 WL 5266026, at *23 (5th Cir. Aug. 16, 2023), the Commission failed to consider the aggregate impact of the numerous recent rulemakings that address similar issues and would require advisers to devote similar legal, compliance, technology, and reporting resources, potentially simultaneously.

Exhibit A

Leading Investors in Private Equity (2021)

2021 Rank	Institution Name	Headquarters	Allocation (%)	Allocation ($m)
1	CPP Investments	Toronto	23.78%	88,677
2	Caisse de dépôt et placement du Québec	Québec	17.80%	51,010
3	GIC Private Limited	Singapore	13.00%	46,800
4	APG	Amsterdam	6.00%	41,747
5	Hong Kong Monetary Authority	Hong Kong	6.32%	34,152
6	Ontario Teachers' Pension Plan	Toronto	19.18%	32,774
7	California Public Employees' Retirement System	Sacramento	6.96%	30,800
8	National Pension Service of Korea	Jeollabuk-do	4.01%	30,688
9	Washington State Investment Board	Olympia	23.13%	29,558
10	California State Teachers' Retirement System	Sacramento	10.34%	29,306
11	Abu Dhabi Investment Authority*	Abu Dhabi	5.00%	28,981
12	Teacher Retirement System of Texas	Austin	14.86%	26,287
13	New York State Common Retirement Fund	Albany	9.80%	24,275
14	Allianz Global Investors	New York	3.18%	22,622
15	Oregon Public Employees' Retirement System	Tigard	23.49%	19,250
16	PSP Investments	Ottawa	14.13%	18,817
17	Japan Post Bank	Tokyo	0.88%	18,674
18	Pensioenfonds Zorg en Welzijn	Zeist	5.90%	18,318
19	Australia Future Fund	Melbourne	13.45%	17,715
20	BCI	Victoria	11.01%	17,248

21	State of Michigan Retirement Systems	Lansing	20.30%	17,093
22	Aberdeen Standard Investments	Aberdeen	4.45%	15,304
23	Florida Retirement System Pension Plan	Tallahassee	7.50%	13,730
24	Virginia Retirement System	Richmond	14.10%	12,986
25	Yale University	New Haven	41.62%	12,986
26	The Wellcome Trust	London	29.02%	12,924
27	International Finance Corporation	Washington, DC	19.61%	11,700
28	Alaska Permanent Fund	Juneau	15.76%	11,647
29	Ontario Municipal Employees Retirement System	Toronto	14.00%	11,526
30	Korea Investment Corporation	Seoul	6.30%	11,511
31	Massachusetts Pension Reserves Investment Management Board	Boston	12.60%	10,949
32	Stanford Management Company	Stanford	26.48%	10,838
33	MN	The Hague	5.00%	10,700
34	Ohio Public Employees Retirement System	Columbus	10.67%	10,500
35	Princeton University Investment Co.	Princeton	39.30%	10,454
36	New York State Teachers' Retirement System	Albany	7.70%	10,380
37	Temasek Holdings	Singapore	4.67%	10,000
38	Manulife Investment Management	Toronto	2.70%	9,653
39	Harvard Management Company	Boston	23.00%	9,637
40	Northwestern Mutual	Milwaukee	3.10%	9,572
41	Maryland State Retirement and Pension System	Baltimore	14.90%	9,318
42	New Jersey Division of Investment	Trenton	10.86%	9,191
43	State of Wisconsin Investment Board	Madison	6.38%	9,176