Truth & Consequences: The SEC's Private Fund Adviser Rules and the Risk of Complacency

Since August 23, when the SEC's final Private Fund Adviser Rules ("PFAR") were adopted, industry reactions have run the gamut, anywhere from relief, to cheer, to outrage. How is it that such disparate responses can exist? According to recent polls, a significant percentage of the industry still feels it does not know enough about PFAR to assess its impact. Many in support of it know only the high-level details proffered by the SEC's accompanying three-page fact sheet, an artfully drafted summary that highlights what it believes are the positive impacts of PFAR. Therein lies the problem.

To read the fact sheet released on that fateful day, one would be forgiven if they felt the SEC heard their salient objections to the proposed rule and compromised accordingly. On the surface, the fact sheet seemed to hold the promise of a reasonable ruleset. Some stopped there, but many coupled this with a surface skim of the 660-page tome. The Adopting Release is a long - and with all due respect, tedious - read, and many still have not given PFAR the thorough read it deserves, footnotes, cross references and all. For in its entirety lie the details that should disturb anyone nonplussed by those who already are.

Understand this: with PFAR, the SEC has wrongfully inserted itself into private contractual, consenting relationships between sophisticated investors and their clients, absent demonstrating the need to do so or a legitimate cost assessment, to the significant detriment of the industry and without the appropriate statutory authority. More objectionable elements from the proposed rule may technically be gone from the final rules, but only because they were recast in such a way that ultimately prevents activities without outright prohibiting them. One cannot embrace the final rules as an outcome any more than they can welcome other overreaching proposals yet to be finalized - perhaps also to be pared back with intent to dissuade legal challenge but still likely to do significant harm to the industry over time.

Bespoke investment arrangements, irrespective of investment mandates, will now be replaced by homogenous investment terms and disclosure to ensure equal treatment. For investment advisers registered with the SEC, costs will go up sharply due to the frequent granular reporting and other regulatory duties now required. With liability now uncertain due to the SEC's concurrent statements on the federal fiduciary duty and Advisers Act Rule 206, many may consider reducing or curtailing more risk-intensive strategies that have produced outsized returns for investors. Assuming fund managers can endure the overwhelming regulatory landscape for private funds in the U.S. - from these rules, added to those already in place and the dozens of other proposed rules pending - what they will have left to offer no doubt will be less attractive to investors and fund managers alike. Everyone loses.

Flourishing private markets offer a wealth of choice to investors. Instead of fostering healthy, lawful growth of U.S. private fund management, PFAR reflects a distaste for investor choice. Add these rules to an ever-expanding regulatory framework, in addition to a breathtaking set of new regulatory requirements and obstacles to come from so many proposed rules yet to be finalized. Collectively, this regulatory onslaught will force fund managers to consider whether the likely insurmountable costs of U.S. regulations are worthwhile. Perhaps they will convert into family offices or exit the U.S. entirely to move out of scope. Undoubtedly, investor choice suffers as a consequence if so.

Investors in private funds are among the largest, most sophisticated investors in the world, particularly those representing sovereign wealth funds, pension funds, professionally managed university endowments and charitable foundations. These investors are certainly capable of negotiating their terms of private investment and do not need the SEC's help. Instead, the SEC has decided to insert itself into the terms of private business relationships, dictating what contractual choices can be made and inflicting exhaustive, one-size-fits-all regulatory requirements.

There is no relationship between private fund advisers and unsavvy retirees, despite that often-repeated narrative. Those retirees are represented by highly sophisticated, well-paid advisers, as noted above, who negotiate on their behalf. No one is being taken advantage of, and no one is forced to invest on what they view to be unfair terms. Sadly, choices evaporate when you overregulate an industry and remove the ability to negotiate and consent to private terms of business.

During the SEC's open meeting prior to voting to approve the final rules, there was discussion about the disproportionate impact of costs to smaller fund advisers. In addressing its evaluation of this potential harm, the SEC's Division of Economic and Risk Analysis offered that private fund advisers who are under the SEC registration asset threshold would be exempt from some of the more cost-intensive aspects of the rules. So then, the key to avoiding regulatory harm is ensuring one is small enough to not matter? When combined with all other obligations of SEC registration, a compelling

argument against registration is forming, something the SEC would be wise to consider in its rulemakings. Incentivizing fund advisers to "stay small" sends a surely unintended message that growth is not encouraged in the U.S. private fund space.

At the same time, smaller investors will be disproportionately negatively impacted, as higher costs will be more meaningful for them. What fewer options are left may well be cost prohibitive. Ironically, the SEC has steadfastly acknowledged the importance of small investors' access to private funds, which provide significant benefits versus other asset classes. It promulgated these rules in the name of fairness, yet the outcome of PFAR may put them out of reach to those most in need of higher returns.

But set this all aside for a moment and consider the regulatory overreach of PFAR. When the SEC decided to push forward with the original proposed rules, it did so absent statutory authority. Nothing changed between then and now that the final rules have been released. Surely, the final rules are less damaging than the proposed rules, though "less bad" is not an outcome anyone should support. Nonetheless, for those who may be willing to accept this less-bitter pill, consider what happens if you give a pass to this attempt by the SEC to expand its remit. Absent objection, an alarming precedent is set because PFAR is not the only ongoing effort to push through new rules that exceed the SEC's statutory authority.

Consider other pending SEC proposed rules that attempt to, for example: (i) redefine who is a securities dealer; (ii) force unworkable contractual obligations on custody arrangements; and (iii) expand the definition of an exchange. There are dozens of proposed rules that chip, or chop, away at the established limits to the SEC's authority, and the Regulatory Flexibility Agenda is filled with the promise of more to come. To expand its remit, the SEC would need authorization from Congress, which it has not requested. However, Congress typically responds to the will of the public, and if the public does not object to this regulatory overreach, Congress is unlikely to act.

What happens from here is uncertain. Litigation, if successful, is unlikely to stave off the implementation of PFAR for many or all of those in scope. As was the case back in 2006, when the SEC was forced to roll back an overreaching rule to redefine private fund "client" and compel registration, those impacted already incurred steep costs and significant business modifications. Some changes were impractical to unwind.

Irrespective of litigation, private fund advisers must begin planning now for PFAR's related compliance dates, which are 18 months and 12 months from today for small advisers and large advisers, respectively. Considering the breadth of the changes put forth, no amount of time will seem sufficient.

If you would like to learn more about the above post or AIMA's work to date or going forward on PFAR, please reach out to **Suzan Rose** at **srose@aima.org**.