

Significant Developments in Private Fund Adviser Regulation 2023

March 22, 2024

During the last year, there were SEC regulatory developments affecting our private fund adviser clients and their counsel. We have set forth below summaries of the following developments that took place during 2023.^[1]

1. Private Fund Adviser Rule Adopted and Challenged.
2. Private Fund Advisers Cited for Breach of Fiduciary Duties.
3. New Short Sale Disclosure Rules.
4. Share Lending Disclosure Rules Adopted.

1. Private Fund Adviser Rule Adopted— and Challenged

New rules for registered private fund advisers with at least \$1.5 billion of assets under management will, unless overturned (see below), become effective September 14, 2024 (or effective March 14, 2025, for advisers having lower assets under management (AUM)).

These rules will require covered advisers to “provide transparency” to their investors regarding performance fees and expenses; and other specified terms by making quarterly reports (this is contained in Rule 211(h)(1)-2). Rule 206(4)-10 mandates an annual financial statement audit of each private fund, and, in connection with an adviser-led secondary transaction, Rule 211(h)(2)-2 requires a fairness or valuation opinion from an independent provider.

In addition to the new disclosures, Rule 211(h)(2)-1 restricts private fund advisers (whether or not registered with the SEC) – unless they have provided disclosure to fund investors – from engaging in certain practices, such as having a fund pay non-*pro rata* investment acquisition expenses. Certain arrangements, such as borrowing or obtaining credit from private funds or having them pay legal expenses associated with investigations of the adviser or affiliates, also require obtaining consent.

Without the satisfaction of particularized disclosure obligations, private fund advisers are also prohibited (by Rule 211(h)(2)-3) from providing certain types of preferential treatment that would have a material, negative effect on other investors (subject to certain exceptions), such as preferential:

- portfolio holding disclosures or
- redemption opportunities.

Groups representing private fund managers have petitioned the Fifth Circuit Court of Appeals to overturn these rules.

The full text of the adopting release can be found at <https://www.sec.gov/files/rules/final/2023/ia-6383.pdf>

The petition for review can be found at <https://www.managedfunds.org/wp-content/uploads/2023/09/MFA-Filing.pdf>.

2. Private Fund Advisers Cited for Breach of Fiduciary Duties

The SEC's Enforcement Division continued to take action against private fund advisers that it deemed to insufficiently protect their investors, including for failure to provide disclosures that would be explicitly required under the new rules. On September 22, 2023, American Infrastructure Funds, LLC, a registered private fund adviser, settled SEC charges of having violated fiduciary duties in three respects:

- it accelerated a portfolio company monitoring fee without timely disclosure to clients;
- it transferred an asset owned by advised funds to a newly-formed private fund that it also advised without adequately disclosing and obtaining investor consent for its conflicts of interest (or alternatively allowing investors to liquidate or exit their investment); and
- it caused one fund to incur expenses that should have been paid by a separate affiliate-advised fund (which had the practical effect of being an undisclosed loan to the affiliate-advised fund).

The adviser was charged with failing to implement proper written policies and procedures to guard against such violations. Sanctions included a censure and cease-and-desist order disgorgement of \$373,368 and interest and penalties of \$1.2 million.

The full text of the settlement can be found at <https://www.sec.gov/files/litigation/admin/2023/ia-6428.pdf>

3. New Short Sale Disclosure Rules

Institutional investment managers that meet or exceed certain reporting thresholds will be required to report their short position and activity data monthly under new Rule 13f-2 and Form SHO. Form SHO will be due 14 days after each calendar month end and will require information related to:

- The end-of-month gross short position, and
- For each individual settlement date during the calendar month, the net activity in the reported equity security.

Although these submissions will be kept confidential, the SEC intends to release summarized data on short sales, with a month's delay.

Additionally, the SEC amended the consolidated audit trail ("CAT") National Market System Plan (the "CAT NMS Plan") governing the CAT to require detailed reporting on short sales by market makers, including whether such sales are part of legitimate market-making activities.

Compliance with Rule 13f-2 and Form SHO will become mandatory on January 2, 2025, with the SEC beginning to disclose collective short sale data in April 2025. The amendment to the CAT NMS Plan will be enforced from July 2, 2025.

4. Share Lending Disclosure Rules Adopted

Securities lending is the market practice by which securities are transferred temporarily from one party, a securities lender, to another, a securities borrower, for a fee. The ultimate borrower typically is a hedge fund that needs to cover a short position and accesses the lending market through their prime broker. The typical lender is a pension fund or mutual fund with a large, static, unleveraged portfolio.

In an attempt to increase transparency in the securities lending market, the SEC adopted new Rule 10c-1a. Compliance will be mandatory starting January 2, 2026.

The rule requires covered persons to disclose to FINRA certain details regarding covered securities loans:

- “Covered person” includes (i) a person that agrees to a covered securities loan on behalf of a lender; (ii) a non-intermediary that acts as a lender in a covered securities loan; or (iii) a broker when borrowing fully paid or excess margin securities,
- “Covered securities loan” means a transaction in which any person lends a reportable security to another person, and
- “Reportable security” means a security for which information is required under certain reporting regimes specified in the rule, such as the CAT NMS Plan or FINRA’s “TRACE” reporting regime.

Exclusions include:

- Positions at a registered clearing agency that result from central counterparty services or central depository services, and
- The use of margin securities by a broker or dealer unless such broker or dealer lends such securities to another person.

There is no *de minimis* exclusion.

Covered persons must report these details to FINRA at the end of each day on which any covered securities loan occurs, and FINRA will then publish certain details of the covered securities loan the morning of the next business day.

A covered person will have to report to FINRA the following information, which will be made public: the name of the issuer; the ticker symbol, ISIN or other security identifier; the date and time the loan was effected; the name of the platform where the loan was effected; the amount of the loan; the type of collateral used to secure the covered securities loan; the rebate rate or any other fee or charges in connection with a covered securities loan collateralized with cash; the lending fee, rate or any other fee or charges in connection with a covered securities loan not collateralized with cash; the percentage of the collateral to the value of the reportable securities loaned required to secure such covered securities loan; the termination date of the covered securities loan; and the type of borrower (i.e., a broker or dealer, a clearing agency, a bank, etc.).

A covered person also will have to provide FINRA with the following information, which will not be publicized by FINRA: the legal name of each party to the covered securities loan; if the person lender is a broker or dealer and the borrower is its customer, whether the security is loaned from a broker’s or dealer’s securities inventory to a customer of such broker or dealer; and whether the covered securities loan is being used to close out a fail to deliver.

[1] 2023 SEC Development Scorecard List profiled as Doc. 11266139.

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related professionals

Ronald M. Feiman / Partner

D 212-238-8880

feiman@clm.com

Guy P. Lander / Partner

D 212-238-8619

lander@clm.com

Andris J. Vizbaras / Partner

D 212-238-8698

vizbaras@clm.com

Paul J. Brown, III / Associate

D 212-238-8723

pbrown@clm.com

Claudia Carbone / Associate

D 212.238.8688

carbone@clm.com