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WEIL PRIVATE FUNDS REGULATORY REVIEW

In recent years, the Securities and Exchange Commission (the "**SEC**" or "**Commission**") has proposed and adopted, and continues to propose and adopt, various rules and changes to the regulatory landscape of private funds and their advisers. This publication discusses the lessons to be learned from the recent decision by the U.S. Fifth Circuit Court of Appeals to vacate the SEC's Private Fund Adviser Rules (the "**Rules**" or "**PFAR**") under the U.S. Investment Advisers Act of 1940, as amended (the "**Advisers Act**").[1]

Further, this publication provides a summary of the SEC's recent settlement of charges against (i) a registered investment adviser for violating certain requirements of Rule 206(4)-1 (the "**Marketing Rule**") under the Advisers Act, including for misleading—and not fair and balanced—performance advertising[2] and (ii) a formerly registered investment adviser and the adviser's co-founder and chief executive officer for violations of the Advisers Act's antifraud and compliance provisions.[3]

Lastly, this publication discusses three recent Supreme Court decisions which (i) overturned the landmark decision in *Chevron v. Natural Resources Defense Council,* reversing the requirement that courts must defer to a federal agency's reasonable interpretation of ambiguous statutory provisions; (ii) held that where the SEC adjudicates securities fraud cases in-house, this violates a defendant's Seventh Amendment right to a jury trial; and (iii) held that the six-year statute of limitations for challenging agency regulations begins to run from the date of injury, rather than the date the regulation is promulgated. [4]

[1] A copy of the court's decision can be found here. A link to a previous alert discussing the decision and to a previous alert discussing the Rules can be found here and here, respectively.

[2] A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

[3] A press release related to the settlements can be found here. A link to the full SEC Orders can be found here and here.

[4] A link to the decisions can be found here, here and here, respectively. Previous alerts discussing these decisions can be found here, here and here, respectively.

DESPITE FIFTH CIRCUIT COURT OF APPEALS VACATUR OF THE SEC'S PRIVATE FUND ADVISER RULES, IMPORTANT LESSONS REMAIN

On June 5, 2024, the U.S. Fifth Circuit Court of Appeals (the "**Court**") ruled in favor of a coalition of private equity industry stakeholders challenging the Rules, vacating the Rules in their entirety. Among other things, the Rules would have (i) prohibited certain types of preferential treatment of fund investors through side letters, and required disclosure to all investors of other preferential terms; (ii) restricted the ability of an adviser to borrow from a fund or charge certain fees and expenses to the fund without disclosure to, and in some cases, consent from, fund investors; (iii) imposed new quarterly reporting requirements on advisers; (iv) limited the ability to allocate fees and expenses related to a portfolio investment on a non-pro rata basis among multiple private funds invested in the same portfolio investment; (v) required an adviser to obtain either a fairness or valuation opinion from an independent provider in connection with any adviser-led secondary transaction and (vi) required an adviser to document its annual compliance review in writing.

In its decision, the Court held that the SEC exceeded its statutory authority in adopting the Rules.

Lessons from PFAR

Though vacated, the Rules and the associated adopting release provide a robust list of issues that the SEC staff currently view as problematic.

Adviser-Led Secondaries

The portion of the Rules that would have required an adviser to obtain a fairness or valuation opinion from an independent provider in connection with an adviser-led secondary transaction signals to the industry that anything less (e.g., reliance on a lead investor's bid to price such a transaction without getting a fairness or valuation opinion) may be scrutinized during an SEC exam.

Moreover, recent amendments to Form PF[5] that became effective in December 2023 (the "**Form PF Amendments**") that require all private equity fund advisers to file quarterly reports with the SEC within 60 days of each fiscal quarter end to report, among other things, any GP- or adviser-led secondary transaction,[6] now provide the SEC staff with affirmative notification of all such transactions (as opposed to asking about them if/when an adviser is subject to routine SEC exam). Given the SEC staff's historical interest in these transactions, private fund advisers should now expect the SEC staff to scrutinize a larger number of such transactions than was the case prior to the effective date of the Form PF Amendments. Advisers engaging in GP-led secondary transactions should develop and implement a transparent process that they can clearly explain to SEC staff, and they should work with regulatory counsel to prepare the above described Form PF event report that will be reviewed by regulators and could set the stage for additional inquiry.

Quarterly Statements

The portion of the Rules that would have required an adviser to distribute to investors in any private fund quarterly statements detailing fees, expenses, compensation paid or allocated to the adviser or its related persons, and performance is reflective of typical issues that the SEC staff scrutinize during examinations and also reflects priorities during SEC examinations.

Additionally, the portion of the Rules that would have required disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated, including "cross references to the relevant section of the private fund's organizational and offering documents that set forth the calculation methodology," highlights the importance of having authority to charge or allocate such items, as well as the importance of calculating them in accordance with the methodologies prescribed in a private fund's organizational and offering documents. While this quarterly reporting is no longer required unless negotiated by limited partners, this process is effectively what SEC staff seek to perform during examinations.

Preferential Treatment

The Rules generally would have prohibited all private fund advisers from: (i) providing preferential redemption terms to an investor in a private fund or in a similar pool of assets that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or similar pool of assets, or (ii) providing certain information about portfolio holdings or exposures to any private fund investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a similar pool of assets. PFAR also would have required disclosure of other preferential economic and other terms granted to some but not all investors.

[5] Form PF is the confidential reporting form completed by private fund advisers for use by the SEC and the Financial Stability Oversight Council.

[6] The Form PF Amendments also require the reporting of a general partner removal or an investor election to terminate a fund or its investment period. The full text of the Form PF Amendments' adopting release can be found here and a related fact sheet can be found here. Exempt reporting advisers are not required to file Form PF as a result of the Form PF Amendments.

While these technical requirements have been vacated, the SEC staff likely will continue to scrutinize any preferential treatment provided to fund investors in the context of private fund advisers' current fiduciary obligations.

Restricted Activities

The Rules would have restricted all private fund advisers from engaging in certain activities and practices, regardless of whether a fund's governing documents permit such activities, unless they satisfy the specific disclosure and, in some cases, consent requirements of the rule. These practices included (i) certain non-pro rata fee and expense allocations; (ii) reduction of adviser clawbacks for taxes; (iii) certain regulatory, compliance, examination and investigation fees and expenses; and (iv) borrowing or receiving an extension of credit from a client.

While these additional restrictions and requirements have been vacated, the SEC staff likely will continue to closely examine whether private fund advisers engage in these activities and, if so, whether they have sufficient authority and have provided sufficient disclosure under current requirements.

Private Fund Audits

The Rules would have required a private fund adviser to cause its private fund clients to undergo financial statement audits that met the requirements set forth in Rule 206(4)-2 under the Advisers Act (the "**Custody Rule**"), effectively eliminating the ability for private fund advisers to utilize the "surprise examination" option found in the Custody Rule.

While the audit requirement has been vacated, the vast majority of private fund advisers will continue to rely on financial statement audits to meet their requirements under the Custody Rule. Custody Rule issues, including the performance of audits, have been, and will continue to be, an intense focus of SEC examinations and enforcement.[7]

Written Annual Compliance Reviews

The Rules would have required that all SEC-registered advisers (whether they advise private funds or not) document the annual review of their compliance policies and procedures in writing.

While most private fund advisers document the annual review of their compliance policies and procedures as a best practice, private fund advisers should expect SEC staff to continue to focus on evidence of the completeness and robustness of their annual reviews. The SEC staff has previously indicated that a failure to demonstrate that an adviser performed an annual review or that an annual review failed to identify significant existing compliance or regulatory problems, is a common deficiency.[8]

NOTABLE ENFORCEMENT ACTIVITY

INVESTOR COMMUNICATIONS ENFORCEMENT ACTION

On May 29, 2024, the SEC announced that it had settled charges against a formerly registered investment adviser, as well as the adviser's co-founder and chief executive officer ("**CEO**"), under the Advisers Act's antifraud provisions in connection with false and misleading statements made to investors in the adviser's flagship fund (the "**Fund**"). The SEC also settled charges against the adviser for violations of the Advisers Act's compliance provision.

From at least February 2020 through August 2022, the adviser is alleged to have made materially false and misleading statements about the Fund's holdings and exposures in a number of communications (e.g., tear sheets, summary portfolio snapshots, etc.) to Fund investors. Certain of the materially false and misleading statements were the result of modifications made by the CEO to holdings and exposures data that was provided to the CEO and used by other adviser employees for purposes of inclusion in communications to Fund investors. Such communications were then distributed to Fund investors without further review by the adviser's compliance personnel or independent verification for accuracy.

Additionally, from late 2022 to early 2023, the adviser is alleged to have failed to disclose a conflict of interest to investors arising from the operation of a separate hedge fund by the adviser's other co-founder, about which the CEO, and by extension, the adviser, had knowledge.

The SEC attributed the above conduct to the adviser's failure to adopt and implement policies and procedures reasonably designed to prevent inaccurate information in investor communications. As a result, both the adviser and CEO were charged with violating Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The adviser was also charged with violating Rule 206(4)-7 under Section 206(4) of the Advisers Act.

These settlements underscore the SEC's continuing focus on the completeness and accuracy of all communications and disclosures by advisers to their investors, and evidences the Commission's willingness to pursue (i) personal enforcement against an adviser's principals should it appear such persons were involved in misleading, or providing false information to, investors and (ii) enforcement regarding undisclosed conflicts of interest, without any allegation of an actual conflict beyond diverted time and attention and a market overlap with other of the adviser's investment products.

[7] In September of 2023, the SEC charged five advisory firms for Custody Rule violations. A press release related to the settlements can be found here.

[8] A link to a risk alert from the SEC's Office of Compliance Inspections and Examinations detailing observations related to investment adviser compliance programs can be found here.

In response to these settlements, advisers should carefully review their investor communication practices, policies and procedures and make any necessary revisions to seek to ensure complete and accurate disclosure to investors, including regarding conflicts of interest, and that such policies and procedures are consistent with the adviser's practices.

MARKETING RULE VIOLATION SETTLEMENT

On June 14, 2024, the SEC announced that it had settled charges against a registered investment adviser under the Marketing Rule and the antifraud provisions of Rule 206(4) of the Advisers Act for misleading, and not fair and balanced, performance advertising.

From at least November 2021 through February 2023, the adviser, a hedge fund that invests predominantly in publicly traded equities, is alleged to have disseminated advertisements via email and data sites to prospective investors in the form of pitch decks and fact sheets. In presenting fund performance in these materials, the adviser allegedly presented performance returns experienced by a single limited partner which differed substantially from—and, at times, was significantly higher than—the performance of the fund, a fact which the adviser did not disclose to investors in the advertisements. Specifically, due to certain FINRA restrictions, certain successful IPO investments made by the fund were credited to such investor's capital account in greater proportion than to the accounts of other investors.

In the order, the SEC noted that the adviser "presented as the Fund's returns the positive 44.8% net performance that the single investor achieved in 2021, whereas the undisclosed net performance of the Fund was negative 5.7% in 2021. In addition, on the first substantive page of the pitch decks, [the adviser] presented performance results, such as the positive 44.8% return for 2021, under the heading 'FUND OVERVIEW,' without an accompanying qualification or disclaimer *on that page* (emphasis added) suggesting such results were anything other than performance results of the Fund."

For this conduct, the adviser was charged with violating Rule 206(4)-8[9] under Section 206(4) of the Advisers Act and the Marketing Rule. Specifically, the order notes that the adviser violated paragraph (a) of the Marketing Rule, which provides, among other things, that an advertisement may not "[i]nclude any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which it was made, not misleading" or "[i]nclude or exclude performance results, or present performance time periods, in a manner that is not fair and balanced."

This action emphasizes the SEC's continued focus on performance advertising under the Marketing Rule, particularly with respect to the "fair and balanced" requirement. In addition, the decision suggests that where an adviser is making assumptions about the track record presented in advertisements, the adviser should consider at a minimum including a general disclaimer on the same page as the performance, rather than leaving the entirety of the disclosures to the endnotes. Finally, advisers should carefully review all forms of performance included in their advertisements and ensure that such performance is not misleading and is presented in a fair and balanced manner, consistent with the requirements of the Marketing Rule.

NOTABLE SUPREME COURT DECISIONS

SUPREME COURT OVERTURNS *CHEVRON*

On June 28, 2024, the Supreme Court, in *Loper Bright Enterprises v. Raimondo* and *Relentless, Inc. v. Dept. of Commerce,* overturned the landmark decision in the 1984 case *Chevron v. Natural Resources Defense Council*. The precedent arising from this case—known as the *Chevron* doctrine—required courts to uphold a federal agency's interpretation of an ambiguous statutory provision so long as such interpretation was reasonable.

In *Loper Bright* and *Relentless,* two fishing businesses challenged a rule promulgated by the National Marine Fisheries Service ("**NMFS**") under the Magnuson-Stevens Fishery Conservation and Management Act (the "**Act**"), which required certain fisheries to bear the cost of carrying federally mandated observers whose purpose was to collect data necessary for the conservation and management of the fishery. The fishing businesses argued that the Act did not authorize the NMFS to require that the fishing industry bear the cost of the observers. The U.S. Court of Appeals for the D.C. Circuit and Fifth Circuit afforded the NMFS *Chevron* deference and rejected these challenges.

The Supreme Court, which agreed only to hear the *Chevron* question, overruled *Chevron* and remanded the cases. Writing for a 6-3 majority divided along party lines, Chief Justice Roberts explained that the Administrative Procedure Act (the "**APA**"), the federal statute setting forth the procedures federal agencies are required to follow, "requires courts to exercise their independent judgment in deciding whether an agency has acted within its statutory authority," and as a result, *Chevron* is inconsistent with the APA. Moreover, Roberts noted that *Chevron* is misguided, because "agencies have no special competence in resolving statutory ambiguities. Courts do."

[9] Rule 206(4)-8 makes it unlawful for any investment adviser to a pooled investment vehicle to "make any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle" or to "otherwise engage in any act, practice, or course of business that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

The decision to overrule the *Chevron* doctrine will likely impact several federal agencies, including the SEC. While the full effects of *Chevron*'s demise are not yet clear, the decision opens the gates for legal challenges against federal agencies' regulations as they are issued. We will continue to monitor the effects of this decision, particularly with respect to the SEC and private fund advisers, and will provide updates on an ongoing basis.

SUPREME COURT RULES SEC'S IN-HOUSE COURTS VIOLATE DEFENDANTS' SEVENTH AMENDMENT RIGHTS

On June 27, 2024, the Supreme Court held in *S.E.C. v. Jarkesy* that when the SEC seeks civil penalties against a defendant for securities fraud, the Seventh Amendment entitles the defendant to a jury trial, and that adjudication of the case in-house before an SEC administrative law judge runs afoul of a defendant's Seventh Amendment rights.

Passed in 2010, the Dodd-Frank Act authorized the SEC to impose civil penalties through its own in-house administrative proceedings without the presence of a jury. In connection with *Jarkesy*, the SEC sought civil penalties against the defendant in connection with the defendant's alleged violation of the "antifraud provisions" of the securities laws, choosing to adjudicate the proceeding in-house, before an SEC administrative law judge and without a jury. The judge found that the defendant and his firm had committed securities laws violations and imposed a $300,000 civil penalty. On appeal, the Fifth Circuit ruled that adjudicating the matter in-house violated the defendant's Seventh Amendment right to a jury trial.

The Supreme Court affirmed the decision of the Fifth Circuit. Chief Justice John Roberts, writing for the majority, which was divided along party lines, said, "A defendant facing a fraud suit has the right to be tried by a jury of his peers before a neutral adjudicator. Rather than recognize that right, the dissent would permit Congress to concentrate the roles of prosecutor, judge, and jury in the hands of the Executive Branch. That is the very opposite of the separation of powers that the Constitution demands."

The decision chips away at the enforcement authority of federal agencies, such as the SEC, which have statutory authority to try cases without juries in front of their in-house administrative law judges. The ruling may require the SEC to bring substantially more cases in federal court, which is far more time consuming and resources-intensive for the SEC than adjudicating in-house. We will provide further updates as they become available.

SUPREME COURT HOLDS THAT NEW CHALLENGES CAN BE BROUGHT TO OLD AGENCY RULES

On July 1, 2024, the Supreme Court ruled in *Corner Post, Inc. v. Board of Governors of the Federal Reserve System* that the six-year statute of limitations applicable to challenges to agency rules under the APA does not begin to run until the date a plaintiff is first injured by a rule, even if that date is long after the date such rule is promulgated.

In *Corner Post*, a convenience store challenged a 2017 Federal Reserve rule, which limited the fees that a merchant can charge a customer's debit card issuer per transaction. The Eighth Circuit Court of Appeals dismissed the action as barred by the APA's six-year statute of limitations, holding that the statute of limitations under the APA begins to run for all plaintiffs on the date the rule is promulgated. The Supreme Court reversed the decision, holding instead that the APA statute of limitations begins to run on the date the plaintiff is first injured by the challenged rule, therefore ruling that the convenience store's challenge was not time-barred.

This decision, combined with the decision in *Loper Bright* and *Relentless* discussed above, will likely impact dozens of federal agencies and subject their rulemaking to a greater number of challenges in the future. In the private fund context, this decision could subject existing SEC regulation to challenges by newly formed investment advisers. We will continue to monitor the impact of this decision and will report updates as they become available.

KEY TAKEAWAYS

Vacatur of Private Fund Adviser Rules

1. On June 5, 2024, the U.S. Fifth Circuit Court of Appeals vacated in their entirety the SEC's Private Fund Adviser Rules.
2. While the Rules would have established a more prescriptive, rules-based regulatory regime for private fund advisers and significantly increased the regulation of the private funds industry, many of the underlying issues reflected in the Rules continue to be significant to private fund advisers during SEC examinations.

Investor Communications Enforcement Action

1. The SEC settled charges under the Advisers Act's antifraud and compliance provisions with a formerly registered investment adviser and the adviser's CEO for (i) disseminating materially false and misleading statements to investors regarding the adviser's flagship fund's holdings and exposures and (ii) failing to disclose conflicts of interest related to an affiliated hedge fund.
2. The settlements reflect the SEC's continued, intense focus on the accuracy and completeness of advisers' communications and disclosures to investors, especially those regarding conflicts of interest.

3. Advisers should carefully review their investor communication practices, policies and procedures and make any necessary revisions to seek to ensure complete and accurate disclosure to investors, and that such policies and procedures are consistent with their practices.

Marketing Rule Violation Settlement

1. The SEC settled charges under the Marketing Rule and the antifraud provisions of the Advisers Act with a registered investment adviser for including performance in its advertisements that was misleading and presented in a manner that was not fair and balanced. In particular, the SEC cited the adviser's failure to disclose assumptions about the advertised track record on the "same page" as such track record.
2. The settlement reflects the SEC's continued, intense focus on advisers' Marketing Rule compliance.
3. Where an adviser includes assumptions in its performance advertising, the adviser should consider, at a minimum, including a general disclaimer on the same page as the performance, rather than leaving the entirety of the disclosures to the endnotes. Advisers should also carefully review the performance they include in their advertisements to ensure that such performance is not misleading and is presented in a fair and balanced manner.

Supreme Court Overturns *Chevron*

1. In overruling *Chevron*, the Supreme Court emphasized that statutory interpretation is fundamentally the responsibility of the judiciary. As a result, federal courts are no longer required to afford deference to statutory interpretation by a federal agency so long as such interpretation is reasonable.
2. This sweeping decision will likely impact federal agencies, including the SEC, and opens the gates for legal challenges to agency rulemaking, potentially curtailing agency authority across various industries.

Supreme Court Decision (*S.E.C. v. Jarkesy*)

1. On June 27, 2024, the Supreme Court held that when the SEC seeks civil penalties against a defendant for securities fraud, the Seventh Amendment entitles the defendant to a jury trial.
2. The ruling may require the SEC to bring substantially more cases in federal court, which is far more time consuming and resources-intensive for the SEC than adjudicating in-house.

Supreme Court Decision (*Corner Post, Inc. v. Board of Governors of the Federal Reserve System*)

1. On July 1, 2024, the Supreme Court held that the APA's six-year statute of limitations for challenging a federal agency's regulations begins to run from the time a plaintiff is first injured by the regulation, and not from the date the regulation is promulgated.
2. This decision, combined with the overruling of *Chevron*, will likely impact dozens of federal agencies and subject their rulemaking to a greater number of challenges in the future. In the private fund context, this decision could permit newly formed investment advisers to bring challenges to existing SEC rules long after they are promulgated.

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