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Explainer on SEC Private Fund Advisers Ruling

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On August 23, the US Securities and Exchange Commission (SEC) adopted final rules governing private fund advisers, an arena which is primarily regulated by the accredited investor rules (Reg D, which permits investors who are financially sophisticated and have a reduced need for regulatory protection, such as individuals who have assets of a million dollars or more or earnings of at least $200,000 or $300,000 as a family in the past two years with the same earnings expectations), and thus is questionable for the SEC to look at. Indeed, many of these funds have much more significant minimums, making private equity untouchable for all but the top 1% of America's wealthy or fewer, or major Pension Funds, Endowments, Foundations, etc.

The final rules require private fund advisers registered with the SEC to provide quarterly statements with standardized disclosures regarding fees, expenses, compensation, and performance, as well an annual financial statement audit of each private fund. They also require SEC-registered advisers to obtain (and distribute to investors) a fairness opinion or valuation opinion from an independent opinion provider in connection with an adviser-led secondary transaction (i.e., when the adviser gives existing fund investors the option between selling their private fund interest and converting that interest for an interest in another vehicle advised by the adviser or an affiliate). The rules prohibit a wide variety of preferential treatment, including preferential redemption terms (unless the ability to redeem is required by law or the adviser offers the rights to others without qualification) and preferential information about portfolio holdings or exposures (unless offered to all investors). The proposal would have restricted the ability of advisers to insulate themselves from liability for negligence, but this was not adopted. The final rules limit a variety of activities, including clawbacks for taxes, extensions of credit, expense allocations, borrowing securities, unless disclosed (and in some cases subject to investor consent). The new rules are quite granular. The new rules, voted 3-2, will go into effect 30 days after publication in the Federal Register, but different parts of the rules will have longer compliance deadlines.

A statement by one of the SEC Commissioners notes that private equity is a misnomer and that private equity today may be as widely dispersed as public company ownership and that behind the Public and Private pension funds, as well as endowments and foundations, are millions of individuals. For example, 26.7 million are working or retired US public plan beneficiaries, who are likely to have increased exposure to private funds and their portfolio company investments. The statement notes that the ultimate beneficiaries look very similar to a public company. Private fund assets under management reached $26.6 trillion dollars in 2022, tripling in the decade. During the past two decades, they grew 4-5 times faster than the overall US economy. Despite this, the statement says the industry is “marred by opacity”, that little is known about the performance, fees, and expenses as well as audited financial statements. It describes the provisions as “foundational and prophylactic”.

While these clearly make sense to some in principle, there are important issues of costs vs. benefits and unintended consequences.

First, even when these rules are implemented, private funds will not be as regulated as mutual funds or ETFs, and private fund investments will be subject to the accredited investor rule, which requires a bar of high income, assets and/or sophistication.

Second, the lead investor in many of these funds are public pension funds, foundations, endowments, and the like, who are risking large amounts of capital relative to other investors, and do so to create above market returns for their investors, such as public employees. Private equity for example make up roughly 11% of US pension funds. Some are a lot higher. Over a ten year period, private equity returned just over 15%, vs. an 11.7 % return for public equity.

Third, the additional costs due to these new regulations may be charged back to investors if disclosed, thus lowering the returns of the funds, and imposing costs which will favor large funds vs. smaller funds. This potentially leads to lower returns for these funds and potential industry consolidation (the top 5 funds represent less than 10% of industry assets, and there are many smaller firms, which different strategies, industry focuses, and often smaller minimums).

While these final rules are generally seen as a pull back by the SEC vs. its proposal, they are likely to be challenged in court. While it is certainly easy to applaud the intent of these new rules, the unintended consequences can be massive for the industry and for investors.