Thursday, February 10, 2022

**SEC Proposes Extensive Regulation of Private Fund Advisers**

The SEC proposed extensive new regulation of private fund advisers under the [Advisers Act](https://www.sec.gov/answers/advisersact.htm). The SEC stated that it recognizes the important role private funds and their advisers play in the financial markets and that the purpose of the amendments - as outlined in the SEC [rule proposal](https://www.sec.gov/rules/proposed/2020-10512.pdf) and [fact sheet](https://www.sec.gov/news/press释放/2020-10512.pdf) - is to expand the regulation of private fund advisers.

**Proposed New Rules and Amendments**

The proposed new rules and amendments would require the following:
• **Quarterly Statement Rule.** The proposal would require investment advisers to distribute quarterly statements to private fund investors, including information related to (i) fees and expenses, (ii) compensation to the adviser or its related persons, and (iii) fund performance. There would be different requirements for liquid funds versus illiquid funds.

• **Private Fund Audit Rule.** The proposal would require financial statement audits (i) at least annually, or (ii) upon liquidation and, in each case, delivered to private fund investors promptly after completion.

• **Adviser-Led Secondaries Rule.** Private fund advisers would be required to receive independent fairness opinions related to adviser-led secondary transactions. This requirement would act as a conflicts-of-interest check.

• **Prohibited Activities Rule.** The proposal would prohibit (i) charging certain fees and expenses to a private fund or its portfolio investments, such as fees for unperformed services or fees associated with the examination or the investigation of the adviser, (ii) seeking reimbursement, indemnification, exculpation or limitation of certain adviser liabilities, (iii) reducing potential clawbacks for taxes, (iv) charging fees or expenses related to portfolio investment on a non-pro rata basis, and (v) receiving an extension of credit from a private fund client.

• **Preferential Treatment Rule (Regulation of Side Letters).** Side letters (i) could not provide preferential terms to certain investors related to redemptions from the fund or transparency, and (ii) other preferential treatment would be subject to a disclosure requirement.

• **Books and Records Rule Amendments.** The amendments to the books and records rule would help increase the SEC's ability to determine whether an adviser has complied with the proposals.

• **Compliance Rule Amendments.** The amendments to the compliance rule under the Advisers Act would require all registered advisers to document their annual reviews.

Comments on the proposal will remain open for 60 days following publication of the proposing release on the SEC's website, or for 30 days following publication in the Federal Register - whichever period is longer.

**Commissioner Statements**

SEC Chair Gary Gensler **supported** the proposed requirements, stating that "it would help investors in private funds on the one hand, and companies raising capital from these funds on the other." He also noted that the private industry currently has approximately $18 trillion in gross assets.

SEC Commissioner Caroline A. Crenshaw **supported** the proposal, explaining how it would "help private fund investors better assess the adviser's performance and decide whether to remain invested in a particular private fund, how to invest other assets, and whether to invest in private funds managed by the adviser in the future."
SEC Commissioner Hester M. Peirce opposed the proposal, stating that "[the proposal] represents a sea change" warning that "... these changes represent a meaningful recasting of the SEC's mission." She cautioned that the proposal (i) raises questions on the rationale for dividing retail from accredited investors, (ii) would divert Examinations and Enforcement resources away from the mission of retail investor protection, and (iii) could "hinder capital formation."

Commentary by Dorothy Mehta

This proposal may be viewed as a point of inflection for the private funds industry. Private funds are important to the capital markets with AUM at north of $18 trillion and continuing to grow. Investors include not only significant institutions, but every major pension plan. Private wealth, from high-net-worth individuals to family offices, is attracted to the management and returns. Moreover, private funds' roles are not limited to vehicles for passive investment - private funds can lend, extend credit, change the direction of public companies, and influence policies in climate change or ESG.

The significance of private funds is, for better or worse, recognized by the SEC in this proposal. While more regulation is generally not welcomed, the practical takeaway is that private funds have attracted the SEC's focus and that focus is not likely to diminish. Advisers must therefore focus on the specifics of each of the proposed new requirements, consider which are reasonable, and which will impose burdens beyond their expected benefits.

CFTC Chair Behnam Testifies on Regulation of Digital Assets

In testimony before the U.S. Senate Committee on Agriculture, Nutrition and Forestry (the "Committee"), CFTC Chair Rostin Behnam reviewed the agency's regulatory oversight of digital assets.

Mr. Behnam pointed to "regulatory gaps presented by innovations in the financial markets" and said there is not a "viable substitute for a functional regulatory oversight regime for the cash digital asset market." He described the CFTC's fraud and enforcement authority powers for addressing misconduct in the regulation of cash markets through (i) oversight and surveillance programs, and (ii) other means, including whistleblower tips or referrals. He stated, however, that no one regulator has "sufficient visibility" in this area to be able to police conflicts of interest and deceptive trading practices.

Mr. Behnam said that while the CFTC's main role is to regulate the commodity derivatives market, there are some characteristics of the digital asset commodity cash market that distinguish it from other cash commodity markets. These characteristics include the following:

- the digital asset cash market is largely composed of retail investors, who are mainly engaged in price speculation;
- speculative fervor around digital assets has led investors to take on a lot of leverage, leading to price volatility; and
complexities around securing and transacting in digital assets have resulted in platforms losing funds to hacks.

Mr. Behnam emphasized the need for additional resources to address issues surrounding digital assets and decentralized financial technologies. He stated that the CFTC is properly positioned to conduct oversight in this area, as its flexible approach to "ensur[ing] market integrity and vibrancy" while also "ensuring individual customer protections" allows it to evolve along with the derivatives markets. With respect to the size of the digital asset market, he highlighted that 13% to 14% of Americans are invested in digital assets, and that "the largest U.S. digital asset exchange reported an increase from 2.1 million to 7.4 million monthly users" in 2021.

Additionally, in a letter to the Committee, Mr. Behnam reiterated the difficulties that could arise while regulating the digital asset market, stressing the differences between digital assets and traditional commodities and how that could affect future regulation.

Mr. Behnam asserted the necessity of taking large coordinated federal measures, whether that includes working with the SEC or contributing to the President's Working Group Project on stablecoins, to properly regulate the digital asset commodity market. He anticipated that subsequent changes in this area will extend beyond the scope of the Commodity Exchange Act.

Commentary by Steven Lofchie

The SEC's approach to the regulation of utility tokens is fundamentally flawed in that it effectively disallows a product that has potentially very significant economic value. See Cabinet Commentary: The Securities Law Treatment of Utility Tokens. While the CFTC does not seem the obvious regulator of these products (as opposed to the SEC), perhaps Congress will decide that it is better to empower a regulator to oversee digital assets rather than one that seems inclined to outlaw many of them.

SEC Proposes Buy-Side Cybersecurity Rules

The SEC proposed cybersecurity risk management and reporting requirements that would be applicable to registered investment advisers, registered investment companies and business development companies. The SEC also proposed amendments to certain rules that govern investment adviser and fund disclosures.

The proposed requirements are meant to (i) address concerns relating to advisers and funds' cybersecurity preparedness and to reduce cyber risk, (ii) improve adviser and fund disclosures, and (iii) improve the Commission's ability to assess systemic risks resulting from cyber incidents.

The proposed rules would require:

- advisers and funds to adopt and implement written policies reasonably designed to address cybersecurity risks;
- advisers to report significant cybersecurity incidents to the SEC on proposed
form ADV-C; and
• advisers and funds to create cybersecurity-related books and records.

The proposal also expands adviser and fund disclosures relating to cybersecurity risks and incidents.

**Commissioner Statements**

SEC Chair Gensler supported the proposed rules and amendments stating that "[t]he proposed rules and amendments are designed to enhance cybersecurity preparedness and could improve investor confidence in the resiliency of advisers and funds against cybersecurity threats and attacks."

SEC Commissioner Caroline A. Crenshaw supported the proposed rules and amendments stating that "robust cyber hygiene practices are critical, both to safeguard investor money entrusted to firms and advisers and to guard against market-wide instability." She noted the importance of investors having relevant information with regard to cybersecurity in order to inform their investment decisions, and commented that "[t]he proposal would require advisers and funds to tell investors about the cybersecurity risks they anticipate, how they would handle those threats, and the nature and scope of any significant cybersecurity incidents that occurred in the past two years."

SEC Commissioner Allison Herren Lee supported the proposed rules and amendments, noting that they include important investor protections designed to address cybersecurity risks in a comprehensive way. She further stated that "our efforts today acknowledge that cybersecurity threats can have a profound impact on the financial system, and establish the groundwork for a more collective and collaborative approach among a variety of parties including the adviser, the fund board, and others."

Commissioner Hester M. Peirce opposed the rules and amendments, suggesting cybersecurity prescriptions could be an easy hook for enforcement even if a firm makes reasonable efforts to comply with the requirements. She further stated that the proposed rules and amendments are not grounded in the correct section of the Investment Adviser’s Act, stating, “[c]entral to my opposition to the investment adviser rule proposal is that we have chosen to ground it in Section 206, the Investment Adviser Act’s anti-fraud provision. Just as we regrettablly did in 2003 when we established a general compliance rule for registered advisers, we cite Section 206(4) as the authority allowing us to impose cybersecurity policies and procedures. This approach does not make sense.”

**SEC Proposes to Shorten Securities Trade Settlement Cycle**

The SEC proposed to shorten the standard settlement cycle for broker-dealer transactions from two business days after the trade date (T+2) to one day after the trade date (T+1).

In order to facilitate the (T+1) settlement cycle, the proposal would require broker-dealers and investment advisers to accelerate the process of confirming and
affirming trade information necessary to prepare a transaction for settlement so that it is completed by the end of the trade date. Certain clearing agencies would be required to facilitate straight-through processing. The SEC stated that the proposal is "designed to reduce the credit, market, and liquidity risks in securities transactions faced by market participants and U.S. investors.

Proposed Amendments

The SEC's Proposed Amendments include, among other things:

- Amending SEC Rule 15c6-1 ("Settlement Cycle") to Establish a Settlement Cycle of T+1 for Broker-Dealer Transactions: The SEC would (i) eliminate the T+4 settlement cycle for new issues, repealing Rule 15c6-1(c) for certain firm commitment offerings, and (ii) adopt new Rule 15c6-2 requiring broker-dealers to complete the allocation, confirmation and affirmation processes no later than the end of the trade date to complete the settlement within the required timeframes under Rule 15c6-1(a).

- Facilitate Straight-through Processing: Clearing agencies would be required to establish, implement, maintain and enforce procedures to facilitate straight-through processing for transactions under proposed Rule 17Ad-27. Under this proposed rule, a central matching service provider also will have to generate and submit a report every 12 months concerning (i) its current policies and procedures for facilitating straight-through processing, (ii) its progress in facilitating straight-through processing during the 12-month period covered by the report, and (iii) the steps the clearing agency intends to take to facilitate and promote straight-through processing during the 12-month period that follows the period covered by the report.

Comments on the proposed amendments will remain open for 60 days following publication of the proposing release on the SEC's website on April 11, 2022, or for 30 days following publication of the proposing release in the Federal Register - whichever is later.

Commissioner Statements

SEC Chair Gary Gensler supported this release saying "it could lower risk to the financial system and drive greater efficiencies in the markets." He also stated that the release would (i) shorten the standard settlement cycle, which should "reduce the amount of margin that counterparties would need to post with clearinghouses," and "would lower risk to and promote greater efficiency in the highly interconnected financial system," (ii) require trade affirmations, confirmations and allocations to occur on trade date T+0, which "further lowers risk in the system," and (iii) require clearing agencies that provide central matching services to have procedures to facilitate straight-through processing.

SEC Commissioner Allison Herren Lee supported the proposal asserting that a reduction in the time that it takes to settle transactions also reduces risk. She stated that such a risk reduction would "result in cost savings throughout the system as less margin is required by clearing agencies." She also added that a
shorter timeframe (i) "reduces the volume and market value of unsettled trades," (ii) "reduce[s] clearing agency margin requirements," and (iii) enables investors to have access to their funds and securities sooner.

SEC Commissioner Caroline A. Crenshaw supported the proposal. She noted that the increasing pace of technological advancements is a reason for which shortening the standard settlement cycle may be "desirable and feasible." She also stated that longer settlement periods could lead the way for other types of risk, including counterparty default risk, market risk, liquidity risk, credit risk and overall systemic risk.

SEC Commissioner Hester M. Peirce supported the proposal. She said that shortening the settlement cycle should "reduce settlement risks and clearing costs" when there is "high volume and volatility."

**Commentary by Steven Lofchie**

In theory, reducing the time periods for which a trade is open and unsettled cuts risk. In practice, whether this is operationally feasible is the question. The various market participant organizations all seem to be supportive, so presumably it can be done.

**Three States Adopt Continuing Education Requirements for Investment Advisers Based on NASAA Model Rule**

Maryland, Mississippi and Vermont adopted continuing education requirements for investment adviser representatives based on the North American Securities Administrators Association ("NASAA") Model Rule.

NASAA stated that these states were the first to require "state-registered and federal covered investment adviser representatives to complete annual continuing education requirements for calendar year 2022."

As previously covered, the Model Rule, adopted by NASAA in November 2020, is intended to:

- "ensure continued competency by IARs" and expand their knowledge base;
- maintain flexibility in IAR continuing education content;
- minimize (i) duplicative continuing education requirements, (ii) compliance burdens, and (iii) the cost to complete continuing education; and
- encourage uniformity among regulators and jurisdictions that implement IAR continuing education.

IARs would be required to complete six hours annually of continuing education with respect to each of (i) Ethics and Professional Responsibility and (ii) Products and Practice pursuant to Model Rule 2002-411(h)("post registration requirements").

NASAA last updated FAQs on the rule in October, 2021.
NASAA urged other states to follow suit.

Primary Sources

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6. **SEC Commissioner Hester M. Peirce: Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking**
7. **CFTC Public Statement: Testimony of Chair Rostin Behnam regarding "Examining Digital Assets: Risks, Regulation, and Innovation"**
8. **CFTC Chair Rostin Behnam: Letter to the U.S. Senate Committee on Agriculture, Nutrition, and Forestry - "Examining Digital Assets: Risks, Regulation, and Innovation"**
10. **SEC-Proposed Rule: Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies**
11. **SEC Cybersecurity Risk Management Fact Sheet**
12. **SEC Commissioner Allison Herren Lee's Statement of Support**
13. **SEC Commissioner Caroline A. Crenshaw's Statement of Support**
14. **SEC Chair Gary Gensler's Statement of Support**
15. **SEC Commissioner Hester M. Peirce Statement of Dissent**
17. **SEC Fact Sheet: Reducing Risk in Clearance and Settlement**
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