SEC Rulemaking Update
Fifth Circuit Vacates Private Fund Rules Final Rulemaking

On June 5, 2024, the U.S. Court of Appeals for the Fifth Circuit issued its opinion that the Securities and Exchange Commission exceeded its statutory authority in adopting the Private Fund Rules and deeming all portions of the rules unauthorized. The court vacated the entire final rulemaking, including the following rules under the Investment Advisers Act of 1940:

- ***Quarterly Statement Rule*** (Rule 211(h)(1)-2)
- ***Private Fund Audit Rule*** (Rule 206(4)-10)
- ***Adviser-Led Secondary Rule*** (Rule 211(h)(2)-2)
- ***Restricted Activities Rule*** (Rule 211(h)(2)-1)
- ***Preferential Treatment Rule*** (Rule 211(h)(2-3)

Definitions established in Rule 211(h)(1)-1, as they related to each of these rules, as well as related amendments to Rule 204-2 (the ***Books & Records Rule***), were also deemed vacated. While not directly related to the Private Fund Rules, in the same rulemaking the SEC mandated that annual compliance reviews required under Rule 206(4)-7 (the ***Compliance Rule***) be written. Because the court's ruling vacated the entire rulemaking, that requirement was also deemed vacated.

Core does not expect that the SEC will file an appeal or re-propose the rules in a different form. However, we do believe that there are currently rules in effect that the SEC can and may utilize to address concerns and require disclosures related to practices that were intended to be addressed by the Private Fund Rules. In particular, the following rules are already in effect and *Core* expects that the SEC will continue to make examination findings, bring enforcement actions, and may issue additional guidance or risk alerts under these rules to curb abuses it identified in the private fund rulemaking.

- ***Marketing Rule*** (Rule 206(4)-1) – This rule is applicable for registered investment advisers (***RIAs***) and covers any marketing materials or advertisements that offer new private funds or advisory services. Among other requirements, the following provisions under the Marketing Rule may be utilized to address misleading performance reporting, which was part of the Quarterly Statement Rule:
    - Prohibits any misleading statements, omissions, and misleading implications
    - Requires net performance calculated in the same manner and covering the same time period as any gross performance
    - Requires that any portfolio company returns be calculated and presented on a net basis

The SEC updated its Marketing Rule FAQ in February 2024, to clarify that private funds that utilize a subscription line of credit (***LOC***) or other borrowing arrangement must either disclose comparable performance both with and without the impact of the LOC or otherwise provide appropriate disclosure describing the impact of the LOC on net performance. This guidance, therefore, had a similar effect as the requirement under the Quarterly Statement Rule to calculate and report levered and unlevered performance with and without the use of the LOC.

- ***Private Fund Anti-Fraud Rule*** (Rule 206(4)-8) – This rule is applicable for both RIAs as well as exempt reporting advisers (***ERAs***) and includes the following prohibitions:
    - Prohibits untrue statements of material fact or omission of material fact in communications with any current or prospective investor in a private fund
    - Prohibits any other act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any private fund

  We expect that the SEC may utilize this rule to address misleading or incomplete information provided to private fund investors in quarterly statements, including failure to fully and fairly disclose all fees, expenses, and compensation arrangements. We similarly expect that the SEC may use the rule to address business practices that they deem problematic related to adviser-led secondary transactions, undisclosed or unapproved borrowing arrangements, or preferential treatment, particularly material economic terms such as revenue sharing, fee/carry breaks, co-investment, liquidity or transparency rights.

- ***Custody Rule*** (Rule 206(4)-2) – This rule is applicable for RIAs that are deemed to have custody of client funds or securities. Private fund managers are generally deemed to have custody of private fund assets based on their role (or that of an affiliate) as the fund's general partner or managing member. Under the Custody Rule, unless each private fund is subject to an annual audit that is conducted by an independent public accountant registered with and subject to inspection by the Public Company Accounting Oversight Board, and audited financial statements are distributed to all fund investors within 120 days of the fiscal year, the RIA must comply with the following provisions:
    - **Surprise Exam** – The RIA must be subject to a surprise exam conducted by an independent public accountant at least once each calendar year without advance notice. The agreement must provide for the first examination to occur within six months after becoming registered as an RIA.
    - **Qualified Custodian** – All funds and securities owned by each private fund (including private portfolio companies or investments) must be held at a qualified custodian (typically a bank or a broker) in a separate account in the fund's name.

- **Custodian Notice** – The RIA must send a written notice to all private fund investors promptly after opening a custodian account and following any changes to such accounts, noting the name and address of the custodian and the account name in which the assets are held.
- **Account Statements** – The RIA must arrange for the custodian to send account statements for such accounts directly to fund investors at least quarterly, identifying the amount (i.e., principal amount, shares, or units) of funds and securities held on behalf of the fund and all transactions in the account during the period.

Accordingly, this existing rule has a similar effect as the requirement under the Private Fund Audit Rule, unless the RIA is able to satisfy these other provisions.

See Court Opinion – https://www.ca5.uscourts.gov/opinions/pub/23/23-60471CV0.pdf