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MARKETING

Key Takeaways for Private Fund Managers From SEC's Latest Reg Flex Agenda

By Robin L. Barton, *Private Equity Law Report*

The Regulatory Flexibility Act (RFA) requires agencies to biannually publish agendas of the regulations that are under development or review. In a 2017 speech, SEC Chair Jay Clayton noted that "the SEC's near-term agenda has swelled over the years," but on average, the SEC has completed only a third of the rules included on it.

In a speech a year later, Clayton observed that the rulemaking expected to be accomplished had become "too aspirational," while noting, however, that the 2018 "Reg Flex" agenda had been more focused than prior agendas, "encompassing 26 different initiatives covering a broad array of topics." More importantly, during the prior year, the SEC advanced 23 of the 26 rules, he stressed. See "SEC's Reg Flex Agenda Promotes Transparency While Adding Potential Compliance Burdens" (Mar. 15, 2018).

On June 24, 2019, the SEC published its Spring Reg Flex Agenda for 2019 in the Federal Register, continuing the trend toward more "tailored yet ambitious" agendas. This article reviews the various components of the latest Reg Flex agenda and highlights the key takeaways for private fund managers.

The Reg Flex Agenda's Components

The SEC's Spring Reg Flex agenda is not just one document; it actually has several components.

Federal Register Agenda

The Reg Flex agenda published in the Federal Register does not contain the complete agenda. Rather, it includes only those agenda entries for which preparation of an RFA analysis is required.
The agenda published in the Federal Register is broken down first by SEC division and then by stage: long-term actions, completed actions, proposed rule stage and final rule stage. The agenda items of most relevance for private fund managers are those related to the Division of Investment Management:

- *Proposed Rule Stage*: Use of Derivatives by Registered Investment Companies and Business Development Companies;
- *Final Rule Stage*: Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures to Retail Customers; and Restrictions on the Use of Certain Names or Titles;

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- *Long-Term Actions*: Reporting of Proxy Votes on Executive Compensation and Other Matters; and
- *Completed Actions*: Amendments to Securities Act Rules Under the Fair Access to Investment Research Act of 2017.

The Form CRS and related items are now complete, as the final rules were released on June 5, 2019.

See our two-part series on the SEC's proposed Form CRS: "An Overview of the Key Requirements" (May 31, 2018); and "Does It Accomplish Its Goals?" (June 7, 2018).

Short-Term Agenda

The SEC's more complete short-term agenda,[1] which includes rulemakings to be accomplished within one year, includes 41 items broken down by stage.

Pre-Rule Stage

There is only one item listed at the pre-rule stage: Harmonization of Exempt Offerings. On June 18, 2019, the SEC published its Concept Release on Harmonization of Securities Offering Exemptions (Concept Release) seeking public comment on ways to harmonize and streamline the rules for exempt offerings to enhance their clarity and ease of use. Comments on the Concept Release may be submitted through September 24, 2019.

Proposed Rule Stage

Of the 22 items listed at the proposed rule stage, two are of particular interest to private fund managers – those covering amendments to:

1. the marketing rules under the Investment Advisers Act of 1940 (Advisers Act); and
2. the custody rules for investment companies and investment advisers.

These items are discussed in more detail below.

Final Rule

The final rule section of the short-term agenda includes 18 items, several of which have already been completed. For example, the final rules for the following were released on June 5, 2019:

- Regulation Best Interest;
- Form CRS; and
- Commission Interpretation Regarding Standard of Conduct for Investment Advisers.

In addition, the final rules have been released on the following items:

- Amendments to Implement FAST Act Report (March 20, 2019);
- Amendment to Single Issuer Exemption for Broker-Dealers (June 10, 2019);
- Auditor Independence With Respect to Loans or Debtor-Creditor Relationships (June 18, 2019);
- Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Capital Requirements for Broker-Dealers (June 21, 2019); and
- Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, And Relationships With Hedge Funds and Private Equity Funds (July 5, 2019).

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Long-Term Agenda

The long-term agenda,[2] includes 52 items that the SEC expects will take more than a year to accomplish. One of the items that is relevant to private fund managers relates to the accredited investor definition, which has been included in the Concept Release noted above.

Rules Under Review

The RFA also requires agencies to review their rules that have a significant economic impact on a substantial number of small entities within ten years of the publication of the rules as final rules. Agencies must publish lists of rules that are scheduled for review and invite public comment on whether the rules should be continued without change, amended or rescinded. Comments were due by August 12, 2019.

Under the RFA, agencies must address the following considerations in the review of each rule:

1. the continued need for the rule;
2. the nature of public complaints or comments received concerning the rule;
3. the rule's complexity;
4. the extent to which the rule overlaps, duplicates or conflicts with other federal rules, as well as, to the extent feasible, with state and local governmental rules; and
5. the length of time since the rule has been evaluated or the degree to which technology, economic conditions or other factors have changed in the area affected by the rule.

On July 11, 2019, the SEC published its list of rules scheduled for review by its staff. As a matter of policy, the SEC reviews all final rules that it published for notice and comment to assess not only their continued compliance with the RFA, but also their continued utility in general. Thus, the published list is broader than that required by the RFA.

The current list of rules under review includes those regarding:

- Risk Management Controls for Brokers or Dealers with Market Access;
- Facilitating Shareholder Director Nominations;
- Amendments to Form ADV;
- Political Contributions by Certain Investment Advisers;
- Amendment to Municipal Securities Disclosure;
- Amendments to Regulation SHO;
- Money Market Fund Reform;
- Amendments to Rules Requiring Internet Availability of Proxy Materials; and
- Shareholder Approval of Executive Compensation of TARP Recipients.

Key Takeaways

"There aren't any surprises in the Reg Flex agenda. Clayton has been fairly transparent from the day he became Chair as to where his focus is: retail investors and capital formation. Many of the items included in the agenda reflect those focuses," said Lowenstein Sandler partner Benjamin Kozinn.

Jane Jarcho, special adviser at Promontory Financial Group and former senior official at the SEC, agreed that the items in the latest Reg Flex agenda "are a fair reflection of the Chair's and the Commissioners' priorities, as well as any statutory requirements." She added that, when she was in the Office of Compliance Inspections and Examinations (OCIE), "the

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two things that we would hear the most about from the industry were the custody rules and the marketing rules. If those items had been missing from the agenda, I would have been surprised."

For additional commentary from Jarcho, see our two-part series: "SEC Division Heads Enumerate OCIE Priorities, Including Cybersecurity, Fees, Bad Actors and Never-Before Examined Fund Managers" (Apr. 28, 2016); and "SEC Division Heads Enumerate Enforcement Priorities, Including Conflicts of Interest, Valuation, Performance Advertising and CCO Liability" (May 5, 2016).

"As a result of the financial crisis, we went through a very long period under the last administration of heavy focus on the hedge fund industry. We can debate whether that was justified, but the hedge fund industry and asset managers broadly are highly regulated now," observed Kozinn. "Many rules were put in place post-crisis, and the industry has adapted to them. Overlaying more regulation will probably have marginal benefit to the markets."

"Also, investors have become much savvier in terms of due diligence and are now serving as another gatekeeper on the regulatory compliance efforts of managers. In the end, there is more light shining on hedge funds, which, pre-crisis, had operated in a pretty dark room with more anonymity," added Kozinn. "The increased compliance and related infrastructure burden, however, has raised the bar for new launches. Deregulation might lower costs and enable more launches, but I don't think investors would allow it."

For Kozinn's reflections on the tenth anniversary of the financial crisis, see our two-part series: "The Collapse and Aftermath" (Oct. 11, 2018); and "Changes to Compliance Programs, Regulation and Fund Strategies" (Nov. 8, 2018).

Marketing Rules

"There has been at least some ambiguity as to whether the marketing rules – as currently written – apply to private fund managers, so the SEC may want to make it clear that they do apply," added Jarcho. "Of course, that doesn't mean that the SEC hasn't cited fund managers for advertising violations under different provisions of the law. That being said, the goal should be to clear up any ambiguity."

"The amendments to the marketing rules under the Advisers Act are at the proposed rule stage, so we will have to see what happens. I am not quite sure, however, that what comes out of that will be significantly beneficial or impactful for hedge fund managers," observed Kozinn. "The best hedge fund managers are not mass marketing to the public. The industry still prides itself on being somewhat exclusive and on catering to investors who really understand the benefits of a hedge fund versus a long-only mutual fund product."
Jarcho and Kozinn agreed that the marketing rules do not reflect today's world, including the use of social media and the ways in which people communicate and make decisions.

See "How to Navigate the Testimonial Rule in the Age of Social Media: Handling Clients' Online Reviews" (Aug. 2, 2018).

"I have heard arguments for allowing retail investors to consume financial advisory services in the same way that they buy, say, electronics – by looking at positive and negative reviews online," noted Kozinn. "In that case, would a manager be able to use

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positive reviews in its marketing by saying, 'We are a great adviser. Look at how many people gave us five stars'? Obviously, that's silly and oversimplified, but I could see customer reviews being allowed in the retail advisory business." He concluded, "If there were amendments to the marketing rules, hedge fund managers would not suddenly present funny advertisements on the internet or be part of Amazon-style reviews. I just don't see that happening."

"I would like to see, however, some clarity about disclosing performance and returns, including the use of hypothetical portfolios," added Kozinn, "At the end of the day, though, managers will always have to comply with the anti-fraud provisions of the Advisers Act and other securities laws in their marketing materials."

"Over the last few years, the Division of Investment Management has issued guidance, FAQs and no-action letters on the marketing rules. It is not ideal, however, to have patchwork guidance on the rules, which requires people to go over here for one interpretation and over there for another," remarked Jarcho. "It's not surprising that the SEC is considering consolidating and updating the rules, but it's hard to write rules for a changing world. Things have changed so much since the rules were drafted, however, so it's probably time to at least take a stab at it."

See our two-part series parsing OCIE's advertising risk alert: "Identifying Advertisements and Common Deficiencies in Performance Advertising" (Jan. 4, 2018); and "Misleading Claims of GIPS Compliance, Past Specific Investment Recommendations and Results of SEC's Touting Initiative" (Jan. 11, 2018).

Custody Rules

Both Jarcho and Kozinn noted that the custody rules were written in response to a problem: the Bernie Madoff scandal. "Some of the custody rules are overbearing and lack practicality. But, they were created in a moment in the SEC's history where it had more egg on its face than at any other time since its creation," remarked Kozinn.

"Any rule that is written in response to a specific situation will have unintended consequences down the road, so it is always good to evaluate how a rule is playing out and whether it is having the desired effect," observed Jarcho. "For example, are the custody rules too restrictive? Are they too lenient? Those sorts of questions should be considered, and I think that is what the SEC is doing: taking a fresh look."

"I heard a lot of complaints about the custody rules during my years in OCIE. The industry views them as a little burdensome," continued Jarcho. "On the other hand, the Commission is always balancing the burdens on industry with the protection of investors."

"Despite faults with the custody rules, fund managers should probably still have to use qualified custodians to broker deals and hold assets, so the SEC can verify the assets and obtain statements from totally independent parties," admitted Kozinn. "Where custody gets a little wonky is with respect to private funds. I don't believe, however, that there is going to be a tectonic change in the custody rules because of concerns about fraud. There are still bad actors in the world."

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See “Advisers Must Ensure Auditor Independence to Satisfy Custody Rule” (Nov. 1, 2018); and “SEC No-Action Letter Eliminates Surprise Examination Requirement Under Custody Rule for Certain Sub-Advisers” (May 19, 2016).

Accredited Investor Definition

“The definition of accredited investor has not changed a lot over the years, so it is wise to assess whether it still makes sense or should be updated,” remarked Jarcho. “The Chairman and some commissioners seem to want more investors to have access to the opportunities offered by private funds and also enable the industry to raise capital more easily. Redefining accredited investor could help accomplish those goals.”

It is not clear that private fund managers would welcome retail investors – or that those investors are interested in access to hedge and private equity funds. In fact, in comments to the Concept Release, Rick Fleming, the SEC’s Investor Advocate, asked the Commission to “evaluate the level of retail investor demand for exempt offerings” and “to assess whether promising companies are interested in having small investors.”

Kozinn echoed those concerns. “Hedge fund managers want capital and would like to have the broadest capital base possible. They also, however, want capital from investors who understand what they do. Simply put, hedge funds are not appropriate for every investor,” he explained. “If investors do not understand what a fund manager is doing and they start losing money or the fund does not perform to their expectations, those investors quickly flee – and that can be very disruptive to the fund’s strategy.”

“Redefining accredited investor could help smaller managers build their capital bases if they can take in money from a broader group,” acknowledged Kozinn. Jarcho agreed that private funds that are struggling to raise capital may view this as another path.

See “SEC Commissioners and Staff Discuss Possible Amendments to Definition of Accredited Investor” (Jun. 2, 2016).

“In the end, however, a manager trying to raise $100 million - $300 million is never going to rely on small checks,” concluded Kozinn. “So, I don’t see tremendous benefits for private funds in expanding the accredited investor definition.” He did suggest that perhaps retirement plans besides pension plans – such as the very large 401(k) market – should have more access to alternatives to give them an opportunity to be more diversified and to make investments that are not correlated on a one-to-one basis with the broader markets.

“401(k)s are generally long-term investments and may have more ability to absorb the ups and downs of the market,” noted Jarcho. Because 401(k)s are individually directed, however, she warned that they do not have the same investor protections as pension plans, which have fiduciaries who are arguably more knowledgeable than average investors.

Pay to Play Rule

The pay to play rule is under review simply because it is ten years old, which means that a review is federally mandated, observed Jarcho and Kozinn, neither of whom believe that the SEC will make any changes to the rule. “I am not aware of anyone advocating for major changes to the rule,” added Jarcho.

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Kozinn noted, however, that the rule is "a very blunt instrument. Even a foot fault can be very costly. People make mistakes, but they are not usually nefarious." As a result, he would welcome some fine-tuning of the rule's restrictions.

For example, Kozinn posited a scenario in which an employee's spouse makes a contribution to the campaign of a designated official. As soon as the fund manager learns of the contribution, the spouse notifies the campaign, which promptly returns the donation. "Should the fund manager still be barred from collecting fees on capital from the relevant government entity?" he asked. "Of course, where do you draw the line? That's the trick."

"It is a strict rule – some might say overly strict. The conflicts and potential conflicts are so significant, however, that they probably justify the rule's strictness," commented Jarcho. "Whenever you move away from very strict restrictions, you enter a slippery slope. This is one of those areas where the perception of conflicts can be so significant that it may warrant extra caution."

See "With Midterm Elections Looming, Fund Managers Must Review the Pay to Play Rule" (Sep. 20, 2018).

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[1] Also available at www.reginfo.gov.

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