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Not-So-New News Flash? Change in Administration Ushers Back a Deregulatory Agenda – Implications for Investment Advisers

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While most industry observers agree that the transition to the new presidential administration will bring with it a deregulatory agenda, members of Katten's asset management regulatory team compiled their Top-5 Holiday Wish List (in no particular order): *[Spoiler Alert: There's a pretty heavy focus on private funds.]*

1. Facilitate Capital Formation In Alternative Investments and Private Funds

For over 20 years, the Securities and Exchange Commission (SEC) Staff has limited closed-end funds from investing in private funds unless the closed-end funds are available only to accredited investors (or qualified purchasers). Also, for over 20 years, the SEC Staff has imposed a flat 15 percent-of-assets ceiling for investments by a closed-end fund in hedge funds and other private funds (for example, hedge funds or private equity funds) that are excluded from investment company regulation by virtue of section 3(c)(1) and/or section 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act). It is unclear what the legal basis is for these limitations under the Investment Company Act or the rules thereunder. The new SEC leadership should consider changing these SEC Staff positions to provide retail investors access to private funds with all of the protections imposed under the Investment Company Act and Investment Advisers Act of 1940 (Advisers Act).

2. Revisit the Accredited Investor (AI) Standard

One of the most common gateways to accessing alternative investments, including private funds, is for an investor to meet the AI Standard. The AI standard is the cornerstone of the private placement exemption in Regulation D, which is usually relied upon when marketing interests in private funds. The AI Standard was last updated and expanded in August 2020 (AI 2020 Final Rule) (e.g., to include, among others, natural persons holding in good standing certain professional certifications or designations, irrespective of income/net worth). However, the AI 2020 Final Rule stopped short of adopting other possible ways of revising (and expanding) the AI Standard that were discussed by the

SEC in the proposing release. This includes a change that would permit investors whose assets are managed by registered investment advisers or broker-dealers to be treated as accredited investors and lower the asset and income thresholds in the definition of an accredited investor. As a result, the current AI Standard financial thresholds remain a significant component of the AI Standard and may no longer be an accurate proxy for an investor's financial sophistication. The new SEC leadership should consider the following:

- revisiting the proposed changes to the AI Standard (never adopted in the AI 2020 Final Rule); and
- revising the AI Standard to incorporate further alternative means of establishing investor sophistication appropriate to allow investors to participate in private offerings of securities – this could be done via SEC rulemaking, including as a result of legislation authorizing and/or directing the SEC to take such action.

3. Address Unresolved Issues In the Custody Rule

In February 2023, the SEC proposed significant amendments to the Custody Rule under the Advisers Act (Rule 206(4)-2)) ("Custody Rule Proposals"). To date, the SEC has not adopted the Custody Rule Proposals and, due to significant industry pushback, it is not anticipated that the Custody Rule Proposals will ever be adopted in their current form. Nonetheless, there are at least two significant unresolved matters with respect to the Custody Rule that could use clarification from the SEC under the new administration either in new proposed rule revisions or in other guidance.

- First, under the Custody Rule, an investment adviser with custody over client funds or securities generally needs to hold those assets at a "Qualified Custodian," which typically means a bank or broker-dealer. However, there are many asset classes such as cryptoassets, certain privately offered securities, derivatives and loans that cannot easily and efficiently be custodied at a Qualified Custodian. It would be helpful to the investment management industry if the new SEC leadership considered providing additional exceptions to the Qualified Custodian requirements with respect to such assets. For example, one possible alternative would be for the SEC to allow registered investment advisers to adopt prescribed policies and procedures designed to protect client assets in cases where it is impracticable to custody such assets at a Qualified Custodian.
- Second, under the Custody Rule, an investment adviser is deemed to have "custody" of client assets if it has the authority to withdraw funds or securities from a client's account. The SEC has provided a limited exception to this definition of custody for investment advisers that trade client securities on a delivery versus payment basis (DVP). DVP is a settlement procedure that requires a buyer's cash payment for securities to be received at or before the seller's delivery of securities. Most publicly traded securities settle on a DVP basis. However, many other securities

do not settle on a delivery versus payment basis and where the investment management industry would benefit from clarity as to when and whether trading authority over such assets would cause an investment adviser to have custody (e.g., certain loan investments).

4. Rethink/Reform "Pay-to-Play" Rule

The "Pay-to-Play" Rule under the Advisers Act (Rule 206(4)-5) has been widely criticized as being unduly punitive and inflexible. Under the rule, donations made by certain personnel of an investment adviser to candidates for, or incumbents in, state or local office who have the ability to hire, or influence the hiring of, the adviser by a government entity (e.g., a government pension plans) can trigger a two-year bar against the adviser receiving compensation from such government entities. Among other critiques levied against the rule:

- Its *de minimis* donation thresholds (which max out at a $350 donation per official, per election – lower in some cases) are so low as to impair legitimate political expression and far below the levels that raise reasonable concerns of undue influence.
- Although there is a limited exception for contributions that the donor claws back within 60 days of discovery, that exception cannot "cure" contributions in excess of $350, making it too circumscribed to be meaningful.
- Under the rule's look-back provisions, donations made by newly hired personnel more than six months before joining an advisory firm are excepted from the rule, but not if that person will be involved in soliciting any clients for their new firm – even if the firm screens the new employee from soliciting or personally profiting from business connected with those prior donations.

New SEC leadership should take a fresh look at the rule, which could include raising the associated *de minimis* thresholds and providing more practical "self-help" remedies for firms to cure inadvertent breaches without having to petition for SEC exemptive relief. More broadly, the SEC could reassess whether the "Pay-to-Play" rule is a necessary or appropriate tool for the agency to retain, or whether existing campaign finance and anticorruption regulations already effectively regulate the underlying issues that the rule was meant to address.

5. Offer Interpretive Guidance Rather Than Regulating by Enforcement

The SEC, under the direction of Chairman Gary Gensler, has certainly been busy. There has been little surprise anymore when it comes to the extraordinary volume and pace of actual and potentially industry-shifting and complex matters arising from both SEC rulemakings and enforcement actions – many of which impact investment advisers. Considering the administration change, new SEC leadership and likely shifting regulatory priorities, the markets and industry participants would benefit from continued willingness at the SEC to consider requests for exemptive orders and interpretive

guidance (where appropriate). For example, in late 2020, the SEC finalized rules governing marketing under the Advisers Act (Marketing Rule), as well as good faith determinations of fair value under the Investment Company Act (Fair Value). The SEC has brought enforcement actions under both rules, which at the same time have presented implementation and interpretive challenges and would benefit from additional Staff FAQ guidance (currently, the Staff has published four and two FAQs on the Marketing Rule and Fair Value rule, respectively). For example, the SEC Staff should:

- Consider, among other things, (i) harmonizing the FINRA advertising rule with the SEC's Marketing Rule; (ii) providing guidance as to what the SEC Staff expects an adviser to do to establish that it reasonably believes hypothetical performance is useful and relevant to its clients; and (iii) clarifying when attribution analysis is considered investment performance that must be presented net of fees.
- Evaluate providing guidance/examples related to investments valued using level 2 inputs.

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