



SEC Changes: New Private Fund Regulations and Enforcement Actions

IN BRIEF:

- Increased the Securities and Exchange Commission (SEC) enforcement actions and new regulations are expected to have a profound impact on the private equity and hedge fund industries in 2024.
- New regulations largely focus on the lack of transparency within the sector and will require many funds to make changes to remain in compliance.
- There are simple yet effective actions that funds can take to address regulatory compliance.

On August 23, 2023, the Securities and Exchange Commission (SEC) [voted on a 3-2 split to amend the Investment Advisers Act of 1940](#). These are the largest changes to fund regulatory requirements in over a decade, and their strong impact on private equity and hedge funds

could last for years to come. Although they were initially proposed in February 2022, the changes reveal trends that may likely continue into Fiscal Year 2024 and beyond.



Overview of New Regulations

SEC Chairman Gary Gensler implied that these regulations will address “opacity” within the sector.

The new rules include:

- ✓ Requirement for funds to provide detailed quarterly statements to investors.
- ✓ Disclosure of side letters and relevant terms to certain investors.
- ✓ Funds will be subject to an annual review conducted by third parties.
- ✓ Requirement of a third-party fairness or valuation opinion for advisers involved on both the buy-side and sell-side of transactions to avoid conflicts.



How the Legislation Will Impact Funds in 2024

The legislation marks the most significant expansion of regulatory guidelines since the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. These regulations are significant because they set rigorous new standards for compliance and transparency, and they are emblematic of the SEC's commitment to continuing to ramp up regulations in the private equity and hedge fund industries. Failure to comply can lead to costly fines.

The SEC's [FY2023](#) showed a 3% increase in enforcement actions compared to [FY2022](#). They also noted that their enforcement actions resulted in "nearly \$5 billion in financial remedies." This is the second highest amount in SEC history after their record-setting year in FY2022. Many assume that this figure will continue to rise once the proposed regulations go into effect.

As funds are required to begin adopting the new laws in FY2024, they can expect that this trend of record-setting enforcement will likely continue. As such, they should aim to embrace the changes and proactively prepare for continued increases to SEC enforcement actions.



This proactivity is especially crucial because the SEC released their [2024 Examinations Priorities](#) a few months ahead of schedule stating, "we are aligning the publication of our priorities with the start of the fiscal year with the hope that it will better inform investors and registrants of the key risks, trends, and examination topics that we plan to focus on in the upcoming year."

This likely indicates that they intend to move swiftly to begin addressing these new priorities, which is further evidence that private funds and advisers should follow suit to mitigate the risk of incurring hefty fines.

Buzzword Comparison of SEC Examination Priorities for Private Funds

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2023

- Hard-to value investments (e.g., crypto and real estate, particularly commercial real estate)
- Use of alternative data
- SPACs
- Adviser-led restructurings (including stapled secondary transactions and continuation funds)

Both 2023-2024

- Conflicts of interest
- Marketing Rule
- Fees and expenses (including post-commitment period management fees, offsets, valuation and disclosures)
- Leveraged private funds
- Side-by-side management with RICs and BDCs
- Affiliated service providers
- Custody Rule

2024

- Funds with exposure to recent market volatility and higher interest rates
- Poor performance, significant withdrawals and valuation issues
- LPACs (including notification and consents)
- Due Diligence practices (particularly private equity and venture capital)
- Form PF



How Funds Can Prepare to Meet Changing Standards

While the exact actions that the commission will take in 2024 remain to be seen, there are cost and time-effective steps that private funds and advisers can take today to update their compliance practices, prepare for the year ahead and mitigate the risk of incurring fines.

Mock Audits Carried Out by a Third Party

One of the best ways to prepare to meet the latest compliance standards is to bring in a third party to conduct a mock audit. This can help funds identify and fortify potential weak points as they adjust to the new rules, ultimately helping them to avoid costly regulatory action. Funds should look to their management liability insurance policies to see if there is potential coverage of these types of audits. Some insurance providers, including Arch Insurance, partner with third-party auditors to offer this service as an enhancement to certain policies.

Internal Audit of Compliance Policies and Procedures

With the latest regulation, one point of note has been the general lack of guidance pertaining to the quality and content of the newly required reporting, and the SEC is expected to release more guidelines in the future. In preparation, funds should examine their internal policies for their ability to adapt to the changing regulatory landscape.

According to a [Law360 Article](#),

“The SEC’s enhanced focus on private fund regulation over the past quarter should motivate fund advisers and compliance personnel to consider whether and how easily their policies and procedures can adjust to future rule changes concerning disclosures, valuations and investor transparency, and how SEC exam staff would consider a firm’s current program in light of the commission’s announced priorities.”

Discuss New Risks With a Trusted Adviser or Insurance Partner

The proposed changes also include a significant restriction regarding investigation expenses that directly impacts a fund’s liability. The revised rules “will not permit an adviser to charge or allocate to the private fund certain investigation costs where there is a sanction for a violation of the Investment Advisers Act of 1940 or its rules,” [according to the SEC](#). This is yet another area where funds should examine their policies and procedures to mitigate any potential liability.

One of the easiest and most important actions funds can take to protect themselves is to ensure that they have the proper loss controls in place. Funds should ensure they preemptively comply with these new regulations before they take effect.

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