

February 2024

Follow [@Paul Hastings](#)



Investment Funds & Private Capital

SEC Updates for Private Funds: Private Fund Rule Litigation and Marketing Rule FAQ

By [John Budetti](#), [Brad Bondi](#), [Nicolas Griepsma](#), [Anna Rips](#), [Ryan Swan](#) and [David Wilson](#)

Private fund sponsors should be aware of two recent SEC regulatory developments with respect to (1) the newly adopted private fund rules (Rule 211(h)(1)-2; Rule 211(h)(2)-3; Rule 211(h)(2)-1; Rule 211(h)(2)-2 and Rule 206(4)-10 under the Investment Advisers Act of 1940, together, the “**Private Fund Rules**”) and (2) an updated FAQ with respect to the marketing rule (Rule 206(4)-1 under the Investment Advisers Act of 1940, the “**Marketing Rule**”).

First, the U.S. Circuit Court of Appeals for the Fifth Circuit heard oral arguments on a legal challenge to the Private Fund Rules. As has been much commented upon, the Fifth Circuit has been a receptive venue for challenges to SEC authority in recent years, and has become a preferred venue for those seeking to challenge federal regulators’ broad claims of power in general. Although there is no way to predict any outcomes in the Fifth Circuit challenge, the three-judge panel subjected the rules to detailed questioning. Second, the SEC released additional guidance concerning the amended Marketing Rule in the form of an FAQ. As discussed below, these developments warrant attention.

Challenge to the Private Fund Rules

On February 5, 2024, the Fifth Circuit heard oral arguments on a challenge to the SEC’s Private Fund Rules that were adopted on August 23, 2023 (please see our summary of the Private Fund Rules for additional information, [available here](#)).

- The National Association of Private Fund Managers is leading the challenge, and includes the private-equity lobbying group American Investment Council and hedge-fund lobbying group the Managed Funds Association. Additionally, the plaintiff-challengers have received support from other business interests, including the U.S. Chamber of Commerce. The challengers are focusing on the provisions of the Private Fund Rules requiring private fund managers to provide investors more information about fees and conflicts of interest. Additionally, they argue that the Private Fund Rules constitute an unjustified government overreach because the statutory provision relied on by the SEC for its authority in promulgating the rules was intended to apply only for retail investors.

- The SEC, whose Private Fund Rules have drawn support from various investors in private equity and the Institutional Limited Partners Association, argues that the rules are necessary because of the private fund industry's opacity with respect to fees, expenses and conflicts of interest. The SEC also contended that the statutory provision is not exclusive to retail investors in the way the challengers contend.
- The Fifth Circuit panel is expected to issue its decision in Q2 2024.

Marketing Compliance FAQ

The SEC updated its Marketing Compliance FAQ ([available here](#)) on February 6, 2024, which features a selection of questions related to the Marketing Rule.

- According to the SEC's update, showing a single investment or group of investments constitutes extracted performance under the Marketing Rule. Under this reading, net performance information would be required for such single investments or groups of investments if gross performance information is included.
 - Although many private fund sponsors had moved in this direction in response to prior SEC guidance, the FAQ likely is a result of SEC examination staff observing variation in sponsor practices in this area.
- Additionally, the FAQ addressed sponsors' calculation of gross and net IRRs when a fund utilizes subscription facilities. The update notes that certain advisers "present gross internal rate of return that is calculated from the time an investment is made (without reflecting fund borrowing or "subscription facilities") and then present net internal rate of return that is calculated from the time investor capital has been called to repay such borrowing."
 - While market practice varies, this approach to net and gross IRR and the effect of subscription lines has been very common among private fund sponsors.
- In the FAQ, the SEC expressed its view that calculating gross IRR and net IRR in this manner may not be in compliance with the Marketing Rule, because "such a presentation would result in IRR calculations being made across different time periods (e.g., gross IRR calculations beginning when funds initially use their lines of credit to acquire investments, and net IRR calculations beginning only once all capital commitments are called and the lines of credit are retired)." Additionally, the SEC believes this approach reflects the use of different methodologies for gross and net IRRs, and also would be inconsistent with the provision of the Marketing Rule requiring that performance be presented in a manner designed to facilitate comparison between net and gross performance.
- Finally, the SEC takes the position that an adviser would violate the Marketing Rule by presenting only net IRR (e.g., for those sponsors who elect not to show gross IRR alongside net IRR) that reflects the impact of fund-level subscription facilities without including either (i) a comparable performance metric, such as the net IRR without such impact, or (ii) appropriate disclosures that describe the impact of including the fund-level subscription facilities on the net performance.

Why it matters:**Challenge to the Private Fund Rules**

The Fifth Circuit has the opportunity to set precedent regarding the SEC's ability to set rules, which could affect other federal regulators as well. The panel was skeptical of the SEC's claims of broad power that enabled it to issue the Private Fund Rules, however they were also concerned about whether the plaintiffs' challenge was broad enough to strike down the Private Fund Rules as a whole.

Marketing Compliance FAQ

The Marketing Rule marked a major change in the regulatory framework surrounding the marketing of private funds (see our summary of the recent first enforcement action alleging a violation of the Marketing Rule, [available here](#)). As with any major rulemaking, sponsors encountered various ambiguities and uncertainties in applying the rule to their marketing materials. While this FAQ will help sponsors better understand the Staff's view on certain aspects of the Marketing Rule, it also includes guidance relating to the use of subscription credit lines that may require changes in the way many sponsors currently calculate and display net IRR metrics. Affected managers should review their marketing materials to evaluate whether any updates are necessary in light of the SEC's recent guidance.

Go Deeper:

[Paul Hastings' Investment Funds & Private Capital](#) practice has a truly global footprint, with more than 70 lawyers across the U.S., Europe and Asia. We represent a diverse set of asset managers, private fund sponsors, and institutional investors.

Our [Investment Funds & Private Capital – Regulatory](#) practice includes attorneys with deep experience handling sensitive and complex regulatory and compliance issues. In the U.S., we regularly advise on Investment Company Act status and structuring issues, private fund investment manager registration, Investment Advisers Act, Securities Act, Securities Exchange Act and other compliance, SEC examinations and enforcement.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

John Budetti
1-212-318-6736
johnbudetti@paulhastings.com

Brad Bondi
1-212-318-6601 / 1-202-551-1701
bradbondi@paulhastings.com

Nicolas Griepsma
1-202-551-1711
nicholasgriepsma@paulhastings.com

Anna Rips
1-212-318-6037
annarips@paulhastings.com

Ryan Swan
1-312-499-6080
ryanswan@paulhastings.com

David Wilson
1-713-860-7311
davidwilson@paulhastings.com