No. 23-60471

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NATIONAL ASSOCIATION OF PRIVATE FUND MANAGERS; ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION, LIMITED; AMERICAN INVESTMENT COUNCIL; LOAN SYNDICATIONS AND TRADING ASSOCIATION; MANAGED FUNDS ASSOCIATION; AND NATIONAL VENTURE CAPITAL ASSOCIATION,

Petitioners,

v.

SECURITIES & EXCHANGE COMMISSION,

Respondent.

On Petition for Review of an Order of the
Securities and Exchange Commission

BRIEF OF INVESTOR CHOICE ADVOCATES NETWORK AND CALIFORNIA ALTERNATIVE INVESTMENTS ASSOCIATION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

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CERTIFICATE OF INTERESTED PERSONS AND CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1 and Fifth Circuit Local Rule 26.1.1, Amici Investor Choice Advocates Network ("ICAN") and California Alternative Investments Association ("CalALTs") state that in addition to the persons listed in Petitioners' Petition for Review (Doc. 1-1) (filed September 1, 2023), and Petitioners' Opening Brief (Doc. 41) (filed November 1, 2023), the following persons and entities have an interest in the outcome of this case:

1. ICAN, *Amicus Curiae;*
2. *CalALTs, Amicus Curiae*
3. Brown, Angela Laughlin, *Counsel for Amici ICAN and CalALTs*;
4. Gray Reed & McGraw, LLP, *Counsel for Amici ICAN and CalALTs*;
5. Morgan, Nick, *Founder & President, ICAN,* and
6. Rizvi, Ghufran, Board President, CalALTs.

ICAN certifies that it is a not-for-profit corporation that has no parent company and no publicly-held corporation owns 10 percent or more of its stock. CalALTs certifies that it is a California not-for-profit

mutual benefit corporation. It has no parent company and no publicly-held corporation owns 10 percent of more of its stock.

November 8, 2023

Respectfully Submitted,
/s/ Angela Laughlin Brown

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IDENTITY AND INTEREST OF AMICI CURIAE[1]

Investor Choice Advocates Network ("ICAN") is a not-for-profit public interest litigation organization committed to serving as legal advocate and voice for investors and entrepreneurs seeking to enter the capital markets. Through its advocacy efforts, ICAN seeks to draw official attention among the judiciary and regulatory bodies to the serious challenges facing investors and entrepreneurs.

The California Alternative Investments Association ("CalALTs") is a California not-for-profit mutual benefit corporation whose members include alternative asset managers, investors, and service providers who are dedicated to the continuing evolution of the alternative asset management industry in California. CalALTs closely tracks the rapidly evolving regulatory landscape and keeps alternative investment managers and their investors informed as international, federal, and state rules evolve.

Government overreach creates barriers to participation in the capital markets. In this case, respondent the United States Securities

[1] All parties consent to the filing of this brief. No party's counsel authored this brief in whole or part, and no party or party's counsel made a monetary contribution to fund preparation or submission of this brief. No person or entity other than *Amici* made a monetary contribution to the preparation or submission of this brief.

and Exchange Commission's ("SEC" or "Commission") overreach is front and center. The SEC has adopted a rule (the "Rule")[2] that restricts and in some cases prohibits the ability of investors in private funds to enter into contractual arrangements the investors prefer. Petitioners, commenters on the rule proposal, and the SEC itself have articulated many of the legal and public policy shortcomings of imposing increased restrictions on the ability of investors to negotiate for the contractual terms they prefer with private funds.

In addition to the reasons set forth in Petitioners' Opening Brief, the Rule is also against public policy because it will decrease choices available to investors without any compelling justification. For this reason, ICAN and CalALTs submit this amicus brief and urge the Court to grant Petitioners' petition and vacate the Rule.[3]

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[2] *See* 88 Fed. Reg. 63206-63390; 17 C.F.R. 275.

[3] CalALTs, together with Connecticut Hedge Fund Association, New York Alternative Investment Roundtable, Inc., Palm Beach Hedge Fund Association, and Southeastern Alternative Funds Association submitted a comment letter to the SEC highlighting their concerns regarding the proposed rules regarding the regulation of private fund advisers. *See* CalALTs, et al., *Comment Letter, Re: Private Fund Adviser Proposal; File No. S7-03-22* (April 25, 2022) *available at* https://www.sec.gov/comments/s7-03-22/s70322-20126536-287211.pdf.

ARGUMENT

I. The Rule Interferes With Investors' Ability to Choose Contractual Provisions

The Rule represents an incredible, unwarranted interference in the ability of fund investors to choose contractual provisions that they prefer. In a misguided effort to protect investors, the Rule imposes a one-size-fits-all set of contractual terms, substituting the Commission's preferred fund contract terms for those that investors and fund managers might consensually agree upon.

In each instance of imposed contractual terms, the Commission has justified the Rule's interference on the basis of various tradeoffs identified by the Commission's staff or by members of the public who submitted comments either for or against a particular requirement. The Commission engaged in what appears to be a paternalistic decision-making process, deciding which benefits outweigh which costs – almost always in the name of investors. This type of weighing of costs and benefits and consideration of tradeoffs is exactly what investors in funds currently do when evaluating contractual terms with fund advisers. The difference, of course, is that the SEC does not know every possible preference that every investor would prefer in every context. As a result,

the Commission ends up with a Rule imposing requirements that all investors must live with, whether or not the Rule's prescriptions bear any resemblance to the investors' own myriad preferences.

Some of the more egregious examples of the Rule's interference with investors' ability to choose are as follows:

- **Interference with "preferential redemption and information treatment."**

The Rule prohibits advisers from granting an investor in a private fund the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on the other investors in that private fund unless: 1) the investor is bound by applicable laws, rules or regulations that mandate such a redemption right, or 2) the adviser has offered the same redemption ability to all existing investors and will continue to offer the same redemption ability to all future investors in the fund.[4]

The Rule further prohibits advisers from providing an investor information regarding portfolio holdings or exposures of a private fund if the Adviser reasonably expects that providing such information would

[4] SEC Release No. IA-6383 at 274; *see also* 88 Fed. Reg. at 63,389/3.

have a material, negative effect on other investors in the private fund unless the Adviser offers such information to all other existing investors in the private fund at the same time or substantially the same time.[5]

- **Interference with expenses charged to the fund.**

The Rule prohibits advisers from charging funds for 1) regulatory or compliance fees and expenses of the adviser or its related persons, and 2) fees and expenses associated with an examination of the adviser or its related persons by any governmental or regulatory authority unless the adviser delivers a written notice of any such fees or expenses, including the dollar amount thereof, to investors in the private fund at least quarterly.[6]

The Rule further prohibits advisers from charging private funds for fees and expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority unless the adviser seeks consent from all investors in such private fund and obtains

[5] *Id.* at 280.

[6] *Id.* at 212.

written consent from at least a majority in interest of the fund's investors (excluding investors who are related persons of the adviser).[7]

- **Interference in periodic reporting to investors.**

The Rule requires covered advisers to prepare quarterly statements (and prescribes the timing for such quarterly statements) that include certain information regarding fees, expenses and performance for each fund advised.[8]

The foregoing aspects of the Rule will surely not be objectionable to *every* fund investor in *every* circumstance, and neither will all of the Rule's various restrictions and prescriptions be preferable to every fund investor in every circumstance. Eliminating options for investors and imposing the Commission's own risk and cost preferences on all fund investors is not the same as protecting investors or acting in the best interest of investors. As SEC Commissioner Hester Peirce has said, "Regulators, risk-averse by nature, also should avoid imposing their own risk tolerance on investors, many of whom are comfortable with taking

[7] *Id.* at 236.

[8] *Id.* at 60; *see also* Final rule 211(h)(1)-2.

risks that regulators would not themselves take in choosing their own investments."[9]

II. The Rule Imposes on Advisers Restrictive, Burdensome Requirements that Investors May or May Not Prefer

For the Commission to impose its risk-and-cost preference on investors in the current circumstances is against public policy. Critically, the Commission's Rule does not comport with the statutory standard, i.e., "in the public interest" or "for the protection of investors." *See e.g.*, 15 U.S.C. § 80b-11(h)(2). As Petitioners observed, Congress regards private-fund investors as particularly capable of protecting their own interests and perfectly capable of negotiating contractual and other terms in connection with fund investments. AR.145:12; AR.226:18; AR.234:8.[10]

The Commission makes frequent reference to the benefits the Rule will bestow on fund investors, drawing the incorrect conclusion that fund investors either don't already enjoy such benefits or would prefer the benefits regardless of any associated tradeoffs or costs. For example, the Commission suggests one aspect of the Rule will save investors from

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[9] Hester M. Peirce, *Investors Have the Right to Make Their Own Decisions Without Regulators Standing in the Way*, CNN Business Perspectives (Oct. 11, 2021) *available at* https://www.cnn.com/2021/10/11/perspectives/sec-commissioner-investors-regulators/index.html.

[10] The administrative record is cited as AR.[document]:[page range].

"need[ing] to engage in their own [investment] research" (88 Fed. Reg. at 63,309/3), but such a "benefit" will not in fact benefit those investors who already have a fiduciary duty to conduct such research. Such are the dangers when regulators impose "benefits" on fund investors by reducing choices.

Similarly, when it comes to costs imposed by the Rule, the Commission sweeps aside the possible preferences of investors who may not want to pay the costs associated with a particular benefit. The Commission concedes the Rule's costs "are likely to fall disproportionately" on smaller or emerging advisers, and those advisers "may find it more difficult to compete" and may "exit, or forgo entry" the market.[11] As explained by the National Association of Investment Companies ("NAIC"), which describes itself as the largest network of diverse-owned private equity firms and hedge funds, in its comment letter to the Commission:

> [The] reporting requirements will add significant costs and expenses that will be difficult for emerging and smaller diverse and women-owned investment firms to bear. Firms with the back-office infrastructure able to comply with the requirements will need to pass the additional costs and expenses to investors, making them and their investment

[11] 88 Fed. Reg. at 63,361/1-2.

> offerings less competitive. Worse still, the additional reporting requirements and expenses will reduce the number of experienced diverse and women investors capable of launching their own firms and put firms unable to afford the burden of the additional expenses out of business.[12]

For every adviser who exits (or never enters) the market, the Commission will have precluded all investors from choosing that adviser's particular bundle of costs, benefits, disclosures, expenses, preferential treatment options, and other tradeoffs that a fund investor might have preferred. Such a result is against public policy.

A. Investors May or May Not Elect to Bargain for Preferential Treatment Restrictions

The Rule's restrictions on "preferential" information and redemption treatment demonstrates perfectly how misguided a one-size-fits-all approach can be.

As an initial matter, the Commission's description of different investors having different information and redemption terms as pejoratively "preferential" reveals the Commission's perspective: a fund that provides certain terms to some fund investors but not others

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[12] National Association of Investment Companies, *Comment Letter Re: Private Fund Advisers, Documentation of Registered Investment Adviser Compliance Review (SEC Release No. 1A-5955; File No. S7-03022 (February 9, 2022))* (April 22, 2022) *available at* https://www.sec.gov/comments/s7-03-22/s70322-20126661-287366.pdf.

"prefers" one set of investors over another. However, different information and redemption terms may simply reflect different tradeoff preferences by different investors, so that the Rule's favoring one level of redemption rights and information access will simply impose that uniform set of preferences on all investors.

The Regulatory Fundamentals Group ("RFG") submitted a comment letter to the Commission making the point that some investors prefer different redemption and information terms than other investors, and this may be particularly true in the case of institutional investors "focused on traditionally underrepresented advisers." According to its website, RFG represents a consortium of 27 institutional investors such as endowments and foundations.[13] In its comment letter to the Commission, RFG specifically responded to the redemption and information restrictions as follows:

> [The Rule's redemption provision] would also reduce liquidity options for investors, thereby reducing efficiency in the market and harming investors, without a countervailing benefit. Private funds have legitimate reasons for offering – and investors have sound business reasons for agreeing to – different liquidity options, including a desire to incentivize investors to lock up their capital longer by offering lower fees in exchange for less liquidity, or to accommodate investors

[13] *Available at* https://www.regfg.com/about.

> who are subject to special regulations (for example, accommodating investors subject to ERISA who wish to avoid a prohibited transaction). Narrowing such options reduces the range of choice in the market. Moreover, [RFG is] not aware of any actual harms that have resulted from varying liquidity rights, other than in a small number of enforcement cases that involved deception and were ably addressed with existing enforcement tools. Once again, [RFG is] concerned that a vague 'material negative effect' standard would incentivize an adviser to make self-protective decisions, such as reducing liquidity options or even dropping some investors.
>
> Transparency and liquidity rights are often necessary conditions for investments into funds managed by emerging advisers in particular, as these rights provide the comfort required to execute higher-risk, higher-return investments associated with emerging advisers and novel strategies. This is especially relevant for RFG members that are focused on traditionally underrepresented advisers or target investments in communities and innovation important to their missions.[14]

Again acting as though it were in the best position to weigh tradeoffs for investors, the Commission purported to address these issues with changes to the proposed rule that completely miss the mark. For one, the Rule permits "preferential" terms so long as they aren't actually preferential.[15] Imposing equal information and redemption terms on all

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[14] The Regulatory Fundamentals Group, LLC, *Comment Letter Re: Proposed Rule on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Release Nos. 1A-5955; File S7-03-22)*, at 2-3 (Dec. 3, 2022) *available at*https://www.sec.gov/comments/s7-03-22/s70322-20152272-320239.pdf.

[15] 88 Fed. Reg. at 63,277/3, 63,281/3-63,282/1.

fund investors in all contexts and circumstances may cause unintended consequences. Again from RFG's comment letter: "The rule as proposed may have the unintended consequence of providing the advisers to funds in which RFG members invest with a rationale for refusing to honor institution-specific needs that often benefit not just the members themselves, but investors as a whole."[16] The Commission prefers that all fund investors have the same redemption and information terms, but such uniformity would harm the current, diverse options available to suit the differing needs and preferences of fund investors.

Consequently, the SEC might easily disagree with an adviser's determination that granting certain rights will not have a material, negative effect on other investors in the fund. This is likely to cause managers to simply not offer those terms – reducing investor choice. This is particularly true when the SEC is also effectively prohibiting managers from defending themselves by using fund assets in the event of an investigation – even where they acted in good faith.

[16] RFG Comment Letter, s*upra* n. 14.

B. Investors May or May Not Elect to Bargain for Fund Expense Restrictions

As to the restrictions on charging regulatory, compliance, and examination fees or expenses to the fund, the Commission again came at the issue as though it were itself an investor, weighing the pros and cons of such fund characteristics.

So, for example, much as an investor might do when evaluating between several fund advisers, *i.e.*, some that permit charging the fund for certain expense and some that don't, the Commission recognized that "[i]t is in investors' best interest for advisers to develop robust regulatory and compliance programs" and "acknowledge[d] that a prohibition of certain of these charges without an exception for instances in which the adviser provides effective disclosure could result in unfavorable outcomes for investors."[17] The Commission then modified the proposed rule – again, much as a particular investor might – to address these tradeoffs, creating a notice and consent exception to the prohibition on charging the fund for certain expenses.[18] Specifically, the Rule requires a fund to pay fees related to government investigations unless "a majority" of investors

[17] 88 Fed. Reg. at 63,264/2 and 63,265/1.

[18] *Id.* at 63,389/1.

consent "in writing" "in each specific instance," once the adviser has "describe[d] how" the fee "is related to the relevant investigation."[19]

While the Rule's notice and consent requirements appear entirely impractical for the reasons Petitioners describe, it is possible that some subset of fund investors somewhere under some circumstances might prefer such a convoluted arrangement. But it is also highly likely that many fund investors would prefer otherwise. This is particularly true because, as with every aspect of the relationship among funds, advisers, and fund investors, there are tradeoffs, and some investors will prefer one set of tradeoffs that another investor would not prefer. The comments by the U.S. Chamber of Commerce regarding the proposed rule are just as true regarding the final Rule in this regard:

> More generally, the practical effects of the Proposal may not be what the Commission intends. The Proposal focuses on preventing advisers from passing on to investors expenses that, from the Commission's perspective, should be for the adviser's account. However, the Proposal does not prevent advisers from charging a management fee, nor does it mandate the amount of any such management fee. In lieu of quantifying their regulatory and compliance expenses to investors, advisers may simply charge a higher management fee, and pay their regulatory and compliance expenses out of the management fee without disclosing those regulatory and compliance expenses to investors. As a result, investors would

[19] *Id.* at 63,270/3-63,271/3 & nn.703, 716.

> ultimately pay the adviser's regulatory and costs indirectly, with less transparency into advisers' actual costs of complying with the Commission's regulatory regime than they now have.[20]

The Commission recognizes that "whether such fees and expenses can be charged to the private fund can be highly negotiated by investors in certain instances."[21] Rather than permit investors to actually engage in such negotiations and choose which terms they prefer (whether involving disclosure and consent, higher or lower management fees, or some other set of terms), the Commission once again imposed a one-size-fits all "solution" that simply reduces the number of permissible options for investors. Such a "solution" is against public policy

C. Investors May or May Not Elect to Bargain for Quarterly Reporting Obligations

The Rule's quarterly reporting obligations are a particularly stark example of a Commission "solution" in search of a problem. As venture capital investment firm Andreesen Horowitz explained in its comment letter regarding the quarterly report requirement:

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[20] U.S. Chamber of Commerce, *Comment Letter Re: Proposed Rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews [Release No. 1A-5955; File No. S7-03-22]; 87 FR 16886*, at 3 (April 25, 2022) *available at* https://www.sec.gov/comments/s7-03-22/s70322-20126616-287265.pdf.

[21] 88 Fed. Reg. at 63,271/3.

> Investors in private funds typically obtain both standardized and bespoke reporting. A private fund manager is typically incentivized to provide investors with fund reporting as it seeks to maintain a productive relationship with investors. In addition, investors, through an association that represents many of them, have promoted standardized investor reporting that has become commonplace in the private fund market. Any standardized reporting a private fund manager provides is frequently accompanied by bespoke investor reporting as well, which evidences the sophistication of the parties involved and the transparency of the market. The Proposed Rules add an additional layer of investor reporting on top of the established market- and investor-driven reporting. *It is both unnecessary and burdensome, and the costs to create the quarterly reports will likely be passed on to investors who already can and do negotiate for the reporting they desire, in the format they desire, and often dictate the methods to calculate performance and other metrics, which vary from investor to investor.*[22]

As with many of the Rule's other provisions, the quarterly reporting requirement simply imposes one, uniform set of terms that the Commission prefers, abandoning the vibrant, diverse set of periodic reporting available to suit the preferences of a vibrant, diverse set of investors. The SEC's imposition of its preferences on all investors is against public policy.

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[22] Andreessen Horowitz, *Comment Re: Request for Comment on Private Fund Advisers; Documentation of Registered Investment Adviser Compliant Review (Release No. IA-5955; File No. S7-03-22)*, at 5-6 (June 15, 2022) *available at* https://www.sec.gov/comments/s7-03-22/s70322-20131404-301563.pdf (emphasis added).

D. "More Disclosure Isn't Always Better"

As this Court recognized last month in deciding that the Commission acted arbitrarily and capriciously in an unrelated rulemaking, "More disclosure isn't always better."[23]

An investor balancing the tradeoffs associated with fund disclosure might consider the costs incurred by the fund manager to collect and disseminate the disclosure information against the benefit of that information to the investor. By placing itself in the position of deciding what private fund investors *should* prefer, the Commission frequently defaults to the position that more disclosure is better. But many investors can and do come to a different conclusion. Robert Greene, President and CEO of NAIC, described an important way in which increased costs for fund managers decrease the choices available to fund investors. Regarding the impact on fund managers who are people of color and women, Greene observed, "Diverse managers are doing a great job and are one of the fastest growing segments in new fund creation. We don't

[23] *Chamber of Com. of the USA v. SEC*, No. 23-60255, at n.18 (5th Cir. Oct. 31, 2023) (citing Eugene G. Chewning, Jr. & Adrian M. Harrell, *The Effect of Information Load on Decision Makers' Cue Utilization Levels and Decision Quality in a Financial Distress Decision Task*, 15 Acct. Org. & Soc'y 527, 539–40 (1990) and Kevin Lane Keller & Richard Staelin, *Effects of Quality and Quantity of Information on Decision Effectiveness*, 14 J. Consumer Res. 200, 211–12 (1987)).

want to see over burdensome regulations and increased risk preventing people from moving from large firms to small firms."[24]

More disclosure is not always better for every investor in every situation. However, the Rule imposes disclosure requirements that some investors may prefer and others will not. The increased costs associated with the Rule's disclosure requirements may prevent some fund managers – including managers from diverse backgrounds – from entering the market or remaining in business at all. The choices available to investors will narrow. The Rule is against public policy.

CONCLUSION

For the foregoing reasons and the reasons set forth in Petitioners' Opening Brief, the Court should grant Petitioners' petition and vacate the Rule.

[24] Gregg Gethard, *Proposed SEC Rules Could Hurt Diverse-Owned Firms,* Buyouts Insider (May 18, 2022) *available at* https://www.buyoutsinsider.com/proposed-sec-rules-could-hurt-diverse-owned-firms/.

November 8, 2023

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CERTIFICATE OF COMPLIANCE

This brief complies with the typeface requirements of Federal Rule of Appellate Procedure 32(a)(5) and the type-style requirements of Federal Rule of Appellate Procedure 32(a)(6), because this document has been prepared in a proportionally spaced typeface using Microsoft Word in 14-point Century font. This document complies with the word limit of Federal Rule of Appellate Procedure 27(d)(2)(a) because, excluding parts of the documents that are exempted by Federal Rule of Appellate Procedure 32(f), this document contains 3,562 words.

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CERTIFICATE OF SERVICE

I hereby certify that on November 8, 2023, I electronically filed the foregoing document with the Clerk of Court for the United States Court of Appeals for the Fifth Circuit using the CM/ECF system, which will cause it to be served on all parties and counsel of record.

/s/ Angela Laughlin Brown
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