SEC Proposal - Private Fund Adviser Rules

Written by Robert G. Sawyer, Samuel Hughes

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Key Takeaways:

- Recently proposed new rules governing investment advisers to private funds would impose substantial new compliance obligations, as well as implement prohibitions on several material, industry-wide practices.
- Investment advisers to any private fund, regardless of strategy and whether registered or exempt, should pay close attention to developments on these proposals and contact counsel with any questions.
- The comment period on the proposed rule is set to expire on April 25, 2022.

Overview:

On February 9, 2022, more than a decade after the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 increased the Securities and Exchange Commission's (the "SEC") oversight of advisers to private funds (pooled investment entities exempt from registration under either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940), the SEC proposed a series of sweeping amendments to the Investment Advisers Act of 1940 (the "Advisers Act") aimed at addressing a number of concerns stated by the Staff regarding private fund transparency and conflicts of interest. The comment period for the proposed rule is set to end on April 25, 2022.

The SEC's proposals would require investment advisers that are registered under the Advisers Act and managing one or more private funds to:

- provide investors with quarterly statements detailing information about private fund performance, fees and expenses;
- obtain an annual audit for each private fund it advises and cause the private fund's auditor to notify the SEC upon certain events; and
- distribute to investors, in connection with an adviser-led secondary transaction, a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider.

In addition, all investment advisers to private funds, whether or not registered with the SEC, would be prohibited from:

- charging fees or seeking reimbursement for certain activities; and
- providing certain types of preferential treatment to favored investors and granting other types of preferential treatment without disclosing such preferential treatment.

The SEC also proposes to require all registered advisers to document the annual review of their compliance policies and procedures in writing.

Quarterly Statement Rule:

Registered investment advisers would be required to distribute, for each private fund that it advises, a quarterly statement to such private fund's investors within 45 days after each calendar quarter end. The statement would include the following:

- All compensation, fees, and other amounts allocated or paid to the investment adviser by the fund during the reporting period, both before and after any offsets, rebates or waivers have been applied, with a separate line item for each category reflecting the total dollar amount;
- All fees and expenses paid by the private fund, including organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses, during the reporting period, both before and after any offsets, rebates or waivers have been applied, with separate line items for each category reflecting the total dollar amount; and
- If applicable, the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the adviser.
- For each covered portfolio investment:
    - All portfolio investment compensation allocated or paid to the investment adviser by the covered portfolio investment during the reporting period, with separate line items for each allocation or payment with the total dollar amount, both before and after the application of any offsets, rebates or waivers; and
    - The fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period, or, if the fund does not have an ownership interest, a brief description of the fund's investment.

Advisers must also include a description of how expenses, payments, allocations, rebates, waivers and offsets were calculated and include cross references to the sections of the private fund's organizational and offering documents that set forth the methodology.

In addition, the quarterly statements must also include information regarding the fund's performance. Levels of disclosure will vary depending on a determination by the adviser of whether the fund is an illiquid fund or a liquid fund. An illiquid fund is a fund that: (i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor's request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments. As noted in the release, many (but not all) funds that are venture capital, private equity or real estate pools would be expected to be illiquid funds. All funds that do not meet the above criteria will be defined to be liquid funds.

If the adviser determines that the fund is a liquid fund, the quarterly statements must show annual net total returns for each calendar year since inception; average annual net total returns over the one-, five-, and ten- calendar year periods; and the cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement. If the adviser determines that the fund is an illiquid fund, the quarterly statements must show both the gross and net internal rate of return and multiple on invested capital. In addition, the quarterly statements must show the gross internal rate of return and multiple on invested capital for the realized and unrealized portions of the portfolio shown separately. The quarterly statements would also include a statement of contributions and distributions for the fund, each shown since the inception of the fund through the end of the quarter covered by the quarterly statement and computed pro forma without the impact of any fund-level subscription facilities.

Lastly, quarterly statements will be required to include the date that the performance information is current through and prominent disclosure of the criteria used and assumptions made in calculating the performance.

Private Fund Audit Rule:

The proposed amendments would require registered private fund advisers to "take all reasonable steps" to cause each private fund they advise to undergo GAAP (or for certain non-U.S. managers GAAP equivalent) financial statement audits, performed by a Public Company Accounting Oversight Board (PCAOB) registered audit firm that is subject to regular inspection by the PCAOB. Such audits would be required to occur annually and upon liquidation, and to be distributed to investors promptly upon completion. As many private funds have existing audit requirements for purposes of compliance with the custody rule (Rule 206(4)-5) and investor requirements, this component of the proposal may be expected to have minimal impact on many firms, although private fund managers who previously relied upon delivery of quarterly account statements by the custodian and an annual surprise examination will be expected to need to implement changes to comply. In addition, auditors would have new requirements to undertake, by written agreement with the private fund manager, to directly notify the SEC of the issuance of a modified audit opinion and upon the termination of such auditor's engagement (or removal from consideration for reappointment).

Adviser-Led Secondaries Rule:

The proposed rule would also require registered private fund advisers to obtain a fairness opinion in connection with an adviser-led secondary. Such opinion would come from an independent provider who would opine on the fairness of the price being offered to the private fund for any assets being sold as part of the transaction. Furthermore, the adviser would also be required to distribute to its investors a summary of any material business relationships the independent opinion provider and adviser have had within the past two years.

Prohibited Activities Rule:

The proposal would prohibit all private fund advisers (registered and unregistered) from engaging in a number of activities and practices, including:

- Charging a portfolio investment for monitoring, servicing, consulting or other fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment;
- Charging the private fund for fees or expenses associated with a governmental or regulatory examination of the adviser;
- Charging the private fund for any regulatory or compliance fees or expenses of the adviser (provided that certain expenses directly related to the private fund, such as Section 13 and Section 16 beneficial ownership reporting, may continue to be a fund expense if so provided by the constituent documents of the private fund);
- Reducing the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders;
- Seeking reimbursement, indemnification, exculpation or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the fund;
- Charging or allocating fees and expenses related to a portfolio investment or prospective portfolio investment on a non-pro rata basis when multiple private funds and other clients advised by the adviser have invested, or will invest, in the same portfolio investment; and
- Borrowing money, securities or other private fund assets, or receiving a loan or an extension of credit, from a private fund client.

Preferential Treatment Rule:

The proposed rule would prohibit an investment adviser from granting an investor in a private fund, or in an investment vehicle with substantially similar investment policies, objectives or strategies (a "substantially similar pool of assets"), the ability to redeem its interest on terms that the adviser expects to have a material, negative effect on other investors in that private fund. Furthermore, an investment adviser could not provide information regarding the portfolio holdings or exposures of the private fund to any investor if the adviser expects that providing the information would have a material, negative effect on other investors in that private fund, for instance, by allowing certain investors to front-run others in decisions to buy or sell interests in the private fund.

In addition, an investment adviser to a private fund would not be able to provide any other preferential treatment to any investor in the private fund unless the adviser provides written notice to each prospective investor in the private fund, prior to the prospective investor's investment in the private fund, regarding any preferential treatment the adviser or its related persons provides to other investors in the same fund. Investment advisers would also be required to distribute to current investors, on at least an annual basis, written disclosure of any preferential treatment provided by the adviser to other investors in the same private fund since the last written notice was provided.

It is worth noting, that while the Commission acknowledges that similar concerns may exist for separately managed accounts running substantially similar strategies to a private fund, its proposed rule does not yet extend to such accounts.

Books and Records Rule Amendments:

To ensure compliance with the foregoing proposed rules, the SEC has also proposed to amend the books and records rule under the Advisers Act in order to require advisers to retain records related to the proposed rules.

Solicitation of Further Comments:

In addition to comments on the amendments summarized above, in the proposing release the SEC seeks comments and has requested input on several additional items that are crucial to the private fund industry. In particular, the SEC solicits input on the following questions:

- Whether certain compensation models, notably the "2 and 20" model, should be prohibited;
- Whether the SEC should impose limitations on management fees or require that it be tied to invested capital or net asset value and prohibit fees on uncalled committed capital;
- Whether advisers should be prohibited from presenting performance with the impact of fund-level subscription facilities;
- Whether a universal template for all private fund quarterly statements should be imposed;
- Whether any of the proposed requirements impose unnecessary costs or compliance challenges; and
- Whether advisers will be able to determine whether a private fund it manages is a liquid or illiquid fund.

If interested, comments may be submitted on the SEC's comment form, which can be accessed here: http://www.sec.gov/rules/submitcomments.htm.

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