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SEC Proposes Broad Regulations Governing All Private Fund Advisers

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Recently, the Securities and Exchange Commission ("SEC" or "Commission") proposed significant new regulations under the Investment Advisers Act of 1940 (the "Advisers Act") governing private fund advisers (the "Proposed Rules"). The Proposed Rules were issued on the heels of a risk alert (the "Risk Alert") released by the SEC's Division of Examinations that highlights many of the same areas addressed by the Proposed Rules, but in the context of issues observed by the SEC staff in recent examinations of registered investment advisers.

According to the SEC, the Proposed Rules are designed to enhance the protection of private fund investors, including increased transparency with respect to fees, expenses, compensation, and performance. The Proposed Rules would meaningfully alter the regulatory landscape that governs all private fund advisers subject to the Advisers Act rules. This includes many advisers that currently qualify as "exempt reporting advisers," as certain requirements of the Proposed Rules (including the prohibited activity) also apply to all advisers, including those that are not registered with the SEC.

Overview of the Proposed Rules:

Specifically, the Proposed Rules would require private fund advisers to, among other things:

- Provide fund investors with standardized quarterly statements disclosing fees, compensation, and expenses (at the fund level and portfolio company level), with cross-references to specific disclosures in offering documents or operating agreements that permit charging the fees and expenses,
- Calculate and disclose the fund's performance, based upon a prescribed methodology,
- Refrain from engaging in certain practices, including charging certain fees and expenses to private funds and seeking indemnification and/or exculpation from private funds in connection with certain activities,
- Provide more fulsome disclosure of preferential treatment afforded to certain investors (*e.g.*, through side letter agreements, etc.) and refrain from certain forms of preferential treatment,
- Obtain fairness opinions for all adviser-led portfolio company secondary transactions,

- Document their annual compliance program review, and
- Acquire and distribute annual audited financial statements for each fund (regardless of the manner in which the fund complies with the similar Custody Rule in the Advisers Act).

As such, private fund advisers should pay close attention to the Proposed Rules and potential modifications suggested during the pending public comment period, which will remain open for 60 days following the publication of the proposing releases on the SEC's website on February 9, 2022 (*i.e.*, April 11, 2022) or 30 days following publication of the proposing releases in the Federal Register, whichever is longer.

The SEC has proposed that the date on which private fund advisers need to begin complying with the Proposed Rules would be one year following the publication of the final rules in the Federal Register, meaning that private fund advisers will have one year after the final rules are approved to comply with all changes. Private fund advisers should spend some of that time conducting a risk assessment and reviewing investor disclosures and internal procedures to measure the impact of the changes.

In reviewing the 341-page release that accompanied the Proposed Rules, it is clear that the SEC has significant reservations about the ability of a substantial segment of the private fund adviser community to address conflicts of interest and disclose fairly the fees and expenses paid by funds and portfolio companies. The SEC seems to be suggesting that many in the industry have not been appropriately addressing issues raised through the SEC's enforcement process or public statements regarding appropriate disclosure and payment of fees, compensation, and expenses. The release included references to a number of enforcement actions in this area, and the SEC noted that, in its view, the problems persist. The SEC also suggested that certain advisers lack internal governance, and that limited partner advisory committees do not provide a meaningful check on an adviser's attempt to overreach. The SEC further opined that an "informational imbalance" exists between advisers and investors with respect to disclosures, and that imbalance needs to be corrected.

While the SEC cited to anecdotal evidence to support these conclusions, the SEC did not provide statistical or empirical data to support its views. In other words, it has painted the industry with a broad brush without providing statistical details to determine the magnitude of questionable behavior in the industry.

Given the scope of the Proposed Rules, we have included below a summary of the key changes and takeaways, but we suggest that legal and compliance personnel contact us with any specific questions.

The Proposed Rules:

The Proposed Rules would require private fund advisers to comply with the requirements and prohibitions set forth below. It should be noted that the Proposed Rules would apply retroactively to existing offering and governing documents that may require amendments or updates to ensure compliance.

Private Fund Quarterly Statements. The Proposed Rules would require private fund advisers to prepare and distribute quarterly statements to investors within 45 days after each calendar quarter end using a standardized format. These statements would be delivered in addition to (or as part of) any other reporting requirements negotiated by investors in the fund.

These statements would require disclosure of (1) all fees, payments, compensation, and expenses paid to the adviser and related persons (a defined term in the Proposed Rules), and (2) performance data.

Disclosure of Fees, Payments, and Expenses. More specifically, the quarterly statements would require:

- A Fund Table that discloses:
  - An itemized accounting of all compensation, fees, and other amounts allocated or paid to the private fund adviser or any of its related persons,
  - An itemized accounting of all fees and expenses paid by the private fund, including accounting, legal, and tax expenses, and
  - The amount of any offsets or rebates carried forward to subsequent periods to reduce future payments or allocations to the private fund adviser or its related persons.
- A separate Portfolio Investment Table that discloses:
  - An itemized accounting of all compensation allocated or paid by any portfolio company/investment to the private fund adviser or its related persons, both before and after the application of any offsets, rebates, or waivers, and
  - The fund's ownership percentage of each "covered portfolio investment" (including intermediate holding companies in certain situations), along with a brief description of the investment.
- Private fund advisers to disclose the methodology used to calculate the fees, payments, and expenses included in the quarterly statements, and *cross-reference the sections of the fund's organizational and offering documents that allow for the specific fees and expenses, and payment calculation and methodology*.

These proposed changes highlight a concern raised in the Risk Alert. For example, the Division of Examinations indicated that a number of advisers to private equity-style funds have failed to follow practices described in fund disclosures regarding the calculation of post-commitment period fund-level management fees.

Disclosure of Performance-related Metrics. The Proposed Rules would also require delivery of quarterly statements that include standardized performance-related metrics, using uniform definitions for performance metrics like internal rate of return ("IRR") and multiple of invested capital ("MOIC"). The performance disclosure requirements include that:

- Quarterly statements for liquid funds (most hedge funds) must disclose the fund's:
  - Annual net total returns for each calendar year,
  - Average annual net total returns over 1, 5, and 10-year periods, and
  - Cumulative total net return for the current calendar year as of the end of the most recent quarter.

- Quarterly statements for illiquid funds (most private equity, venture capital, infrastructure, real estate, and debt funds) must disclose, *since inception and without the impact of any fund-level subscription line credit facilities*, the fund's:
  - Gross and net IRR for the full fund since inception,
  - Gross and net MOIC for the full fund since inception,
  - Gross IRR and gross MOIC shown separately for the realized and unrealized portions of the fund's portfolio,
  - A statement of the fund's aggregate contributions and distributions,
  - A statement of the fund's net asset value, and
  - The criteria and assumptions used in calculating performance.

The Proposed Rules define many of the terms referenced in connection with the performance disclosures, and would require that performance be calculated without reflecting the impact of any fund-level subscription-based credit facilities or similar arrangements (which the SEC suggests could distort IRR and MOIC calculations).

The SEC stated clearly in the release that one of the goals of the proposed performance disclosures is to standardize disclosures and allow investors to "compare apples to apples." Additionally, the Risk Alert issued by the Division of Examinations predicted this sea change by highlighting several ways in which investment advisers have allegedly made inaccurate or ambiguous statements regarding performance in their marketing—*e.g.*, by using unrealized gains to paint a rosier picture of a fund's success.

Preferential Treatment. The Proposed Rules would prohibit private fund advisers from directly or indirectly providing:

- *Preferential terms to certain investors regarding withdrawals/redemptions or information about portfolio holdings or exposures* if the adviser reasonably expects that doing so will have a material, negative effect on other investors in the fund, and
- *Any other preferential treatment to any investor in the fund unless the adviser provides written notice* regarding the preferential treatment to (1) *prospective* investors before they invest in the fund, and (2) *current* investors on an annual basis.

Most advisers are aware of the issues created by providing any preferential terms on redemptions or other forms of liquidity and/or providing selective disclosure of material information regarding underlying investments.

However, the requirement that funds provide both prospective and current investors with details regarding any preferential treatment that they afford to other fund investors would potentially require a significant change in current market practice with respect to the use of side letter agreements. Currently private funds regularly enter into side letter and other similar arrangements granting more favorable rights and privileges to certain preferred investors in the ordinary course of capital raising. In the case of most private equity-style funds (particularly closed-end funds) with a defined capital raising period, these side arrangements are shared with fund investors *after* the end of the capital raising

period, and in the case of most hedge fund-style funds (open-end funds) that are constantly raising new capital, these side letters are sometimes shared on a regular basis or not shared at all.

Private Fund Adviser Prohibited Activities. In addition to specific disclosure requirements, the Proposed Rules also prohibit specific activity and transactions. The SEC believes that these activities place a private fund adviser's interests ahead of those of the fund investors, and that disclosure does not address the conflicts associated with this activity in a satisfactory way. The Proposed Rules would prohibit the following:

Charging Certain Fees to Portfolio Companies. The Proposed Rules would prohibit a private fund adviser from 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. This ban appears intended to target accelerated monitoring fees which have been a focus in the industry, but also implicates other fee arrangements.

Examination or Investigation Fees and Expenses. The Proposed Rules would prohibit a private fund adviser from charging the fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority (regardless of whether such examination or investigation uncovers any questionable or troubling conduct).

Regulatory and Compliance Fees and Expenses. The Proposed Rules would prohibit a private fund adviser from charging the fund for any regulatory or compliance fees or expenses of the adviser or its related persons (but would permit charging a private fund for regulatory, compliance, and similar fees and expenses directly related to the activities of the private fund (*e.g.*, Form D-related fees and expenses)) if adequately disclosed.

Clawback of Carried Interest Gross of Taxes. The Proposed Rules would prevent a private fund adviser from reducing the amount of any carried interest clawback obligation by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders. This would be a significant change to current market practice and could have a meaningful adverse impact on adviser personnel who have already paid taxes on carried interest in the year received. We expect this will be an area of focus for private fund advisers during the comment period.

Exculpation and Indemnification. The Proposed Rules would prevent a private fund adviser from seeking reimbursement, indemnification, exculpation, or limitation of its liability from a private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, recklessness, or, importantly, negligence. Private fund advisers have historically negotiated exculpation and indemnification provisions with investors in fund constituent documents. While standards may be negotiated in private funds, a simple negligence standard, rather than a gross negligence standard, would be a significant departure from current industry practice. We also expect this may be another area of focus for private fund advisers during the comment period.

Non-Pro Rata Fees and Expenses. The Proposed Rules would prohibit a private fund adviser from allocating fees and expenses related to a portfolio investment (or proposed portfolio investment) on a non-pro rata basis when multiple private funds and other clients of the adviser have invested (or proposed to invest) in the same portfolio investment. On its face, this prohibition would also apply in the case of allocating broken-deal expenses among private fund clients and other clients, including co-investors.

Borrowing from a Private Fund. The Proposed Rules would prohibit a private fund adviser from borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client.

We note that the Division of Examinations again highlighted some of these activities as problematic in the recent Risk Alert.

Adviser-led Secondary Transactions. Adviser-led secondary transactions are an increasing trend in the private fund market and occur when a private fund adviser initiates a transaction whereby private fund investors are provided the option of liquidating their interests in the fund (and/or a particular portfolio investment or group of portfolio investments) or converting those interests into interests in a new investment vehicle advised by the adviser on new terms, typically with an extended holding period for the underlying investment(s).

The Proposed Rules prohibit these types of transactions unless the adviser distributes a fairness opinion from an independent valuation firm to fund investors before the transaction closes (along with a written summary of any material business relationships the private fund adviser or any of its related persons has had in the past two years with the independent opinion provider).

This requirement highlights the SEC's concerns regarding conflicts of interest that can arise in adviser-led secondary transactions due to the fact that the private fund adviser both structures and leads the transaction, and may stand to profit at the expense of private fund investors.

Compliance Procedures and Practices. Currently, the Advisers Act requires registered investment advisers to review their compliance program annually. Under the Proposed Rules, registered investment advisers would also be required to document this annual review in writing.

The Proposed Rules currently do not provide a particular standard regarding what information must be included in the written documentation of the annual review. The SEC believes the new rule will allow its staff to better determine whether an adviser has complied with the annual review requirement. As written, the rule potentially will allow the SEC's staff to apply a subjective standard when evaluating whether a registered investment adviser has met its annual review obligation.

Private Fund Adviser Audits. The Proposed Rules would require registered private fund advisers to obtain from an independent public accountant an annual audit of the financial statements of all of its managed or advised funds. This requirement would apply regardless of the manner in which the adviser satisfies the Advisers Act Custody Rule with respect to its managed or advised funds.

This provision details various requirements for these audits, including that the results be sent promptly to all of the private fund's investors. The most interesting of these requirements is arguably that the independent accountant must agree to notify the SEC in writing if they:

- Issue an audit report to the private fund that contains a modified opinion, or
- Resign or are terminated from the engagement.

According to the SEC, timely receipt of this information will readily enable it to identify private fund advisers that are potentially engaged in misconduct or have other compliance issues.

Books and Records to be Maintained by Private Fund Advisers. The Proposed Rules would require private fund advisers to create and maintain various records related to many of the new requirements discussed above, including:

- *Quarterly Statements.* Each quarterly statement, all records evidencing the calculation method for each metric contained in any such statement, and documentation substantiating the determination that a private fund client is liquid or illiquid,
- *Preferential Treatment.* Any preferential treatment notice that is distributed to investors,
- *Adviser-led Secondary Transactions.* Any fairness opinion or material relationship summary that is distributed to investors, and
- *Private Fund Adviser Audits.* Each private fund client's audited financial statements that are distributed to investors or documentation of the adviser's efforts to cause a private fund client that it does not control to undergo a financial statement audit.

For all of the above records that are distributed to investors, the Proposed Rules also require the private fund adviser to maintain a record of each addressee and the corresponding date sent, address, and delivery method for each addressee.

Proposed Changes to Form PF:

It is worth noting that the SEC announced in late January 2022 certain proposed changes to Form PF that relate to many of the changes in the Proposed Rules and issues highlighted in the Risk Alert. The proposed changes to Form PF would:

- Require certain large hedge fund advisers to file reports on Form PF within one business day of certain reporting events, including certain extraordinary investment losses, significant margin and counterparty default events, material changes in prime broker relationships, changes in unencumbered cash, operations events, and events associated with withdrawals/redemptions,
- Require advisers to certain private equity funds to file reports within one business day of certain reporting events, including execution of adviser-led secondary transactions, implementation of general partner or limited partner clawbacks, removal of a fund's general partner, termination of a fund's investment period, or termination of a fund,
- Reduce the reporting threshold for large private equity advisers from $2 billion to $1.5 billion and require additional disclosure on fund strategies, use of leverage, and certain portfolio-level information, and
- Require large liquidity fund advisers to report information similar to that included in Form N-MFP required of money market funds.

The Takeaways:

The Proposed Rules, which are subject to further modification, will impose a number of disclosure and record-keeping requirements on private fund advisers for the first time. As such, we recommend that legal and compliance professionals consider the following:

- From an enforcement and litigation perspective, private fund advisers should focus on the area of greatest liability. Among other things, if the Proposed Rules become final, we expect significant scrutiny where a private fund adviser's prior disclosures on the relevant topic (*e.g.*, fees, compensation, and performance) materially differ from disclosures required under the new rules, or where an adviser cannot readily tie a fee calculation back to a disclosure in an offering document.
- Because of the broad scope of the rules, advisers should engage in a risk assessment to determine the level of impact on their business activities, including a review of the private fund adviser's offering and governing documents (*e.g.*, offering memoranda, pitch books, DDQs, LPAs, and LLC operating agreements) and periodic disclosures to investors on the topic of fees, expenses and compensation.
- Private fund advisers should consider the impact of the proposed limitations and disclosure requirements applicable to preferential treatment agreements on their side letter agreements and expect that, even if these rules do not become final, the Division of Examinations staff will continue to view these arrangements critically and require appropriate disclosures.
- Even if some or all of the Proposed Rules do not become final, the SEC will still pursue those areas that do not result in a rule change through enforcement investigations and examinations.

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

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