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ALERTS

Proposed SEC Rule Would Expand Private Fund Compliance Obligations, Investor Protections

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Highlights

In early February 2022, the SEC issued a proposed rule that reflects a significant shift in the agency's approach to private fund regulations

Under the proposed rule, SEC-registered private fund advisers would face new disclosure and reporting obligations

The rule would also prohibit a number of practices that are currently commonplace in the private funds industry

On Feb. 9, 2022, the Securities and Exchange Commission (SEC) voted to propose a rule that, if implemented in its current form, would have far-reaching implications for investment advisers to private funds.

The proposed rule would create new standardized reporting and audit requirements for SEC-registered advisers to private funds and greatly expand SEC-registered adviser disclosure obligations concerning fees, expenses, fund performance and portfolio holdings for the private funds they advise. The proposed rule would also prohibit a number of market practices for all registered and unregistered advisers that are currently commonplace in the private funds industry. The vote in favor of the

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proposed rule was a 3-1 split decision, with Commissioner Hester Peirce, the lone dissenter, describing the proposed rule as a "sea change" that would represent "a meaningful recasting of the SEC's mission."

The public comment period will remain open until the later of 30 days following publication of the proposed rule in the Federal Register, or April 11, 2022.

If adopted, the SEC is proposing a one-year transition period for advisers to come into compliance with the proposed rule.

Taken together with the SEC's proposed amendments to Form PF announced on Jan. 26, 2022, and the risk alert published by the SEC's Division of Examination on Jan. 27, 2022, the proposed rule reflects a shift in tone and approach by the SEC with respect to the regulation of private funds. Echoing remarks made by SEC Chairperson Gary Gensler at the Institutional Limited Partners Association Summit in late 2021, the proposed rule states that the SEC believes additional disclosure requirements and prohibitions are necessary to address private fund industry "practices [the SEC] has observed [that] are contrary to the public interest and protection of investors."

The proposed rule includes the following changes to address the SEC's concerns.

Quarterly Financial Statements: While many private fund advisers contractually agree to provide quarterly financial statements to their investors, the proposed rule would create an affirmative regulatory obligation for SEC-registered private fund advisers to do so. The rule would standardize certain quarterly reporting requirements which, according to the SEC, would promote transparency for investors and allow them to more readily compare the expenses and fees charged by different private funds. The mandated reporting (to be delivered within 45 days of quarter-end) would include:

- **Fees and Expenses:** The proposed rule would require private fund advisers to disclose the following information to investors in a specified format:

    1. **Adviser Compensation.** A detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the private fund during the reporting period ("adviser compensation"), including (but not limited to) management, advisory, sub-advisory or similar fees or payments, and performance-based compensation.

    2. **Fund Expenses.** A detailed accounting of all fees and expenses paid by the private fund during the reporting period other than adviser compensation including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses.

    3. **Fee Offsets.** The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons.

- **Portfolio Investment-Level Disclosure:** The proposed rule would require advisers to disclose the following information with respect to any "covered portfolio investment":

    1. A detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period, including (but not limited to) origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees.

    2. The private fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period.

- **Calculations and Cross References to Organizational and Offering Documents:** The proposed rule would require each statement to include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers and offsets are calculated. The quarterly statement also must include cross references to the relevant sections of the private fund's organizational and offering documents that set forth the calculation methodology.

- **Performance Disclosures:** The proposed rule would require advisers to include standardized fund performance information in each quarterly statement provided to fund investors. In the proposed rule, the SEC emphasized that, while the performance disclosure elements of the recently adopted marketing rule provide additional protections for prospective investors prior to investing in a private fund, current investors should also receive additional disclosure concerning ongoing fund performance so that they can better monitor investment progress over time. Different types of private funds would be subject to different performance disclosure obligations:

    1. **Illiquid Funds:** An adviser to an illiquid fund (which would be defined to include most private equity and other closed-end funds) would be required to disclose the internal rate of return and multiple of invested capital for the illiquid fund (calculated on a gross and net basis) and the gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately. Each measure would need to be shown since the fund's inception and computed without the impact of any fund-level subscription facilities. The proposed rule also would require advisers to provide a statement of contributions and distributions for such fund.

    2. **Liquid Funds:** An adviser to a liquid fund (which would be defined to include every fund that is not an illiquid fund) would be required to disclose the liquid fund's annual net total returns for each calendar year since inception, the liquid fund's average annual net

total returns over the preceding one-, five-, and ten-calendar year periods and the liquid fund's cumulative net total return for the current calendar year as of the end of the most recent calendar quarter.

Private Fund Audits: The proposed rule would require SEC-registered private fund advisers to obtain an annual audit of the financial statements of the private funds they manage. The audit must be performed by an independent public accountant registered with the Public Company Accounting Oversight Board, must be prepared in accordance with U.S. Generally Accepted Accounting Principles ("GAAP") (or, in the case of foreign private funds, must be reconciled with GAAP) and "promptly" delivered to investors upon completion. This aspect of the proposed rule was modeled on the "limited partnerships subject to annual audit" portion of the current Rule 206(4)-2 under the Advisers Act (the "custody rule") and mirrors obligations that many advisers subject to the custody rule are already fulfilling. However, in addition to broadly expanding the scope of private fund advisers that would be required by regulation to arrange for audits of the private funds they advise, there are several significant differences from the custody rule, notably that auditors will be required to notify the SEC (i) promptly in the event they issue an audit report that contains a modified opinion and (ii) within four days of resignation or dismissal from their engagement with a private fund.

Adviser-Led Secondaries: The proposed rule would require SEC-registered investment advisers to obtain a fairness opinion in connection with certain adviser-led secondary transactions where an adviser offers fund investors the option to sell their interests in the private fund or exchange their interests for new interests in another vehicle advised by the adviser. The proposed rule would require the adviser to obtain a fairness opinion prior to completing the transaction, and would also require the adviser to disclose to investors a summary of any material business relationships the adviser has or has had with the opinion provider in the previous two years.

Prohibited Activities: Perhaps the most significant departure from the SEC's past practice is the agency's proposal to prohibit a private fund from undertaking a number of market practices and arrangements, several of which are long-standing and commonplace throughout the industry and highly negotiated with sophisticated, well-represented investors. In a departure from the SEC's historical focus on appropriate disclosure of such practices (along with any accompanying risks and conflicts of interest) to investors, the proposed rule would affirmatively prohibit all private fund advisers from "engaging in certain sales practices, conflicts of interest, and compensation schemes" that the SEC has determined are contrary to the public interest and investor protection. Unlike other aspects of the proposed rule, these prohibitions would apply to both registered and unregistered investment advisers to private funds. In the proposed rule, the SEC stated its belief that these market practices cannot be adequately addressed by enforcement actions and disclosure alone. Specifically, the SEC would prohibit private fund advisers from engaging in the following activities:

- Charging certain fees and expenses to a private fund or portfolio investment, including accelerated monitoring fees,

fees or expenses associated with an examination or investigation of the adviser or its related persons by the SEC and other governmental or regulatory authorities or regulatory or compliance expenses or fees of the adviser or its related persons;

- Charging fees and expenses related to a portfolio investment on a non-pro rata basis when multiple private funds and other clients advised by the adviser have invested in the same portfolio investment;
- Reducing the amount of any clawback of "carried interest" distributions (e.g. "GP clawback") by the amount of certain taxes;
- 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 private fund;
- Borrowing money, securities or other fund assets, or receiving an extension of credit, from a private fund client;
- Providing certain "preferential" side letter treatment to private fund investors, including preferential redemption rights and preferential information rights regarding portfolio holdings or the exposure of the private fund;
- Providing any other side letter provisions (e.g. excuse rights) to private fund investors without disclosing such arrangements to prospective and current investors.

Books and Records; Compliance Rule Amendment: The proposed rule would require SEC-registered investment advisers to maintain books and records documenting the fund's efforts to comply with the disclosure and reporting requirements included in the rule. The proposed rule would also amend Rule 206(4)-7 under the Advisers Act to require that all SEC-registered investment advisers would be required to document their annual review of the adequacy of their compliance policies and procedures in writing.

To obtain more information, please contact the Barnes & Thornburg attorney with whom you work or Scott Beal at 646-746-2021 or sbeal@btlaw.com, David P. Hooper at 317-231-7333 or david.hooper@btlaw.com, or Travis Ortiz at 646-746-2027 or travis.ortiz@btlaw.com.