Professional Perspective

SEC's Proposed Rules for Private Funds Advisers

Michael Renetzky, Gerald Francese,
Heather Stone & Shawn Durrani, Locke Lord

Bloomberg Law

Read Professional Perspectives | Become a Contributor

Reproduced with permission. Published May 2022. Copyright © 2022 The Bureau of National Affairs, Inc.
800.372.1033. For further use, please contact permissions@bloombergindustry.com

SEC's Proposed Rules for Private Funds Advisers

Contributed by Michael Renetzky, Gerald Francese, Heather Stone & Shawn Durrani, Locke Lord

On Feb. 9, 2022, the U.S. Securities and Exchange Commission (SEC) proposed a package of new rules and amendments to existing rules under the Investment Advisers Act of 1940 (Advisers Act). The proposed rules were published in the Federal Register on March 24, 2022.

The proposal continues the trend of the SEC expanding its oversight of investment advisers, including exempt reporting advisers, and in many cases seeks to preempt heavily negotiated arrangements between private fund advisers and investors. The SEC's stated goal is "to protect those who directly or indirectly invest in private funds by increasing visibility into certain practices, establishing requirements to address certain practices that have the potential to lead to investor harm, and prohibiting adviser activity that [the SEC believes] is contrary to the public interest and the protection of investors."

This article outlines the proposed rules as well as considerations we believe are worthy of particular focus.

Background

In the years following the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the SEC focused most of its regulatory oversight regarding private funds on requiring investment advisers to register under the Advisers Act, and collecting information regarding their private funds.

The proposed rules appear to signal a change in the SEC's primary focus, and a desire to bring private advisers (and, indirectly, private funds) that are exempt from registration more directly into the regulatory spotlight. In addition, some of the proposed rules would create minimum federal standards of conduct that would, in effect, supplant less restrictive state law and negotiated contracts between private fund advisers and their investors.

We note that many of the proposed rules align with the current third edition of the "ILPA Principles," a set of principles published in June 2019 by the Institutional Limited Partners Association (ILPA). For example, both the ILPA Principles and SEC proposed rule 211(h)(1)-2 require the delivery of detailed financial disclosures, including the disclosure of fees and expenses paid by a fund and a fund's portfolio investments, to private fund investors on a quarterly basis.

ILPA is an organization whose membership comprises endowments, public and private pensions, foundations, and other institutional investors, and which encourages certain standardized disclosure and governance terms for private funds and private fund advisers.

The proposed rules generally address the following topics and would affect registered investment advisers (RIAs), exempt reporting advisers (ERAs) and state-registered or otherwise exempt advisers (SIAs), as indicated:

Proposed Rule	**Topic of Proposed Rule**	**Affected Advisers**
211(h)(2)-1	Prohibitions on engaging in certain sales practices, conflicts of interest, and compensation schemes	RIAs, ERAs and SIAs
211(h)(2)-3	Preferential treatment or terms provided only to a subset of private fund investors related to redemption and information disclosure –side letter terms	RIAs, ERAs and SIAs
211(h)(2)-2	Fairness opinion required for private fund adviser-led secondary transactions	RIAs
206(4)-10	Mandatory audit of private fund financial statements to, among other things, serve as a check against misappropriation of assets and calculation of adviser fees	RIAs
211(h)(1)-2	Delivery and content of quarterly statements to private fund investors–uniformity of fee presentation	RIAs

©2022 The Bureau of National Affairs, Inc.

It is important to note that many private fund advisers already observe key practices and requirements addressed in the proposed rules, such as the delivery of annual audited fund financial statements to private fund investors. Other matters, however, have historically been the subject of lengthy contractual negotiations between private fund advisers and their investors and/or applicable state law, such as the standard of conduct for the private fund adviser and how and when a general partner's clawback obligation will be calculated or reduced.

Given the prescriptive nature of the proposed rules, their preemptive nature over applicable state law and existing adviser contracts and arrangements, private fund advisers need to pay careful attention to the proposed rules and how they might impact the adviser's operations and relationships with investors.

Prohibitions on Certain Adviser Activities & Practices

The proposed rules would prohibit advisers from engaging in certain conduct that the SEC has determined to be contrary to the public interest and the protection of investors. The prohibited conduct would include certain sales practices, transactions that spur conflicts of interest, and compensation schemes.

ERAs and SIAs should pay particular attention to these items, as some of the proposed rules have not historically applied to them. The proposed application of such substantive regulation to ERAs and SIAs is significant and a substantial leap. As originally contemplated, ERAs and SIAs were not to be subject to substantive Federal regulation—other than general antifraud principles and various reporting requirements.

The SEC specifically notes that its intention is to address practices that have persisted, despite repeated attempts to stamp out such activity via enforcement actions.

If the proposed rules are adopted, the following activities and practices would be prohibited for any RIA, ERA or SIA, regardless of whether such activities and practices are permitted under a private fund's governing documents, applicable state law, or contractual arrangements with investors.

Prohibited Activities	
Fees for Unperformed Services	Charging a fund's portfolio companies for monitoring, services, consulting, or other fees that the adviser does not, or does not reasonably expect to, provide to the portfolio investment. These fees are sometimes referred to as "accelerated payments" because some private advisers have contractual arrangements with portfolio companies that mandate that fees will be paid for a specified term, even if the portfolio company is disposed of by the private fund prior the end of that term. While this rule does not bar the advance payment of fees for services that an adviser expects to provide to a portfolio company, it does require that any such advance payments be refunded if such services are not provided. The proposal is somewhat unclear as to whether a contractual provision that provides for advance payments is permitted. Likely, the SEC staff would functionally interpret this to require a savings clause that calls for a refund of fees for services not actually provided – similar to the longstanding staff enforcement position regarding investment management fees charged in advance.
Certain Regulatory Fees & Expenses	Charging a private fund for: fees or expenses associated with any examination or investigation of an adviser or its related persons by any governmental or regulatory authority; or regulatory/compliance fees or expenses of the adviser or its related persons. The proposal does state, however, that it is not intended to change the practice of charging funds for regulatory and compliance activities directly related to the activities of the private fund.
Reducing Clawbacks for Taxes	Reducing the amount of a clawback obligation by actual, potential or hypothetical taxes applicable to the adviser or its affiliates.
Limiting or Eliminating Liability for Adviser Misconduct	Seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors related to a claim of breach of fiduciary duties, willful malfeasance, bad faith, negligence, or recklessness. The SEC noted that these prohibitions would apply, despite the fact that any such contractual terms may be permissible under state law. A notable potential impact of this portion of the proposal is that this could be the tipping point to eliminate—as a practical matter—use of the "gross

 ©2022 The Bureau of National Affairs, Inc.

	negligence" standard in advisory contracts. The SEC staff has—practically since right after issuing the No Action Letter to Heitman Capital Management, LLC issued Feb. 12, 2007, blessing the "savings clause" concept—indicated its discomfort for a gross negligence standard. This year, the SEC has become more vocal regarding its opposition to use of the gross negligence standard. Both the Comprehensive Capital Management, Inc. enforcement action (Jan. 11, 2022) and the Division of Enforcement Risk Alert regarding its Observations from Examinations of Private Fund Advisers (Jan. 27, 2022) have made this clear. If the proposed rules are adopted without change, it is likely that the gross negligence standard will become unenforceable. This is not necessarily a bad thing, but it certainly underscores a clear disregard for state law and freedom of contract.
Certain Non-Pro Rata Fee & Expense Allocations	Charging or allocating fees and expenses related to a portfolio investment, or potential portfolio investment, on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested, or propose to invest, in the same portfolio investment. The SEC specifically addressed broken deal expenses, indicating that arrangements where an adviser's "main" fund bears broken deal expenses on behalf of co-investors that would have been required to participate in a deal are not permitted under the rule. The SEC clarified that to the extent a potential co-investor does not have a binding obligation to participate in a transaction, the proposed rule would not prohibit the allocation of expenses attributable to such potential co-investor to a private fund that would have participated in the transaction, subject to disclosure of such costs in the private fund's offering documents.
Borrowing	Borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client.

Conditions to Preferential Treatment for a Subgroup of Investors

The Proposed Rules would prohibit any RIA or ERA from granting preferential terms to a private fund investor, without exception, regarding the ability to redeem its interest or the provision of information about a private fund's portfolio holdings or exposure, in each case that the adviser reasonably expects to have a material, negative effect on other investors in such private fund or a substantially similar pool of assets managed by the adviser or its related persons, or any other preferential terms, unless the adviser provides each prospective investor written disclosure prior to such investor's investment in the fund and each current investor written disclosure on an annual basis of any preferential terms provided during the preceding year.

The SEC stated that a determination of whether any term is "preferential" depends on the facts and circumstances, which may lead to inconsistent application of this rule by advisers. Assuming an adviser determines a term is preferential, it must provide specific disclosure to prospective and current investors. For example, if an adviser provides an investor with lower fee terms in exchange for a significantly larger investment than others, the SEC indicated that mere disclosure that some investors pay a lower fee would not be enough. The adviser must describe details of the lower fee term, including the applicable rate—or range of rates, if multiple investors—in order to comply with the rule.

This portion of the proposed rules may significantly affect an adviser's side letter and fundraising practices. Many private equity fund advisers, for example, generally grant "most favored nation" clauses and allow investors to make MFN elections on a post-closing basis. While providing copies of side letters may comply with the rules, the disclosure would likely have to be made prior to the closing of the fund.

Adviser-Led Secondary Transactions

The proposed rules would require an RIA, prior to completing an "adviser-led secondary transaction" with respect to a private fund, to distribute the following to the private fund's investors: a fairness opinion from an independent opinion provider; and a written summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider. The SEC indicated that a wide scope of transactions may be covered by this rule, from single asset transactions to full fund restructurings.

 ©2022 The Bureau of National Affairs, Inc.

Audited Financial Statements

The proposed rules would require RIAs to cause each private fund they advise to undergo a financial statement audit at least on an annual basis and upon liquidation of such private fund. The SEC stated that the new audit rule is based on the existing custody rule, and noted that a financial statement audit performed by an adviser in accordance with the custody rule would largely be the same under the proposed audit rule. Certain key differences are set forth below.

Audit Rule Requirements (as Proposed)		**Differences From Custody Rule**
Auditor Requirements	The adviser or private fund must enter into an agreement with the auditor that requires the auditor to notify the SEC promptly upon issuing an audit report that contains a modified opinion and within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.	Notice by the auditors regarding the circumstances set forth to the left are not required under the custody rule.
Distribution Requirements	The proposed audit rule requires audited financial statements to be distributed promptly upon completion of the audit, but does not specify specific timeframes.	Audited financial statements must be delivered within 120 days of the end of the fiscal year, or 180 days in respect of funds-of-funds.

The proposed audit rule would, in effect, supplant the Advisers Act surprise examinations alternative to satisfy the custody rule. Since most private funds do currently undergo an annual financial statement audit related to the custody rule, this portion of the proposal is likely to have relatively little impact. For private funds that an RIA does not control—presumably this would most commonly be a situation where the RIA is a subadviser to the private fund—the proposed audit rule would require an RIA to "take all reasonable steps" to cause any such private fund to undergo an audit in compliance with the rule.

Delivery & Content of Quarterly Statements

The proposed rules would require an RIA to cause its private fund clients to deliver quarterly statements to investors with minimum disclosures regarding fees, expenses, and performance within 45 days after each calendar quarter end. As noted below, the performance disclosures vary in part on whether the private fund is an "illiquid fund"—e.g., a private equity fund—or a "liquid fund"—defined in the Proposed Rules as any private fund that is not a liquid fund, e.g., a hedge fund.

Quarterly Statement Minimum Disclosures	
Fund Table	A table for the private fund that discloses detailed accounting information, at the fund level, of the following, presented both before and after the application of any offsets, rebates, or waivers: *Fees/Compensation*: All compensation, fees, and other amounts allocated or paid to the adviser or its related persons during the quarter, with separate line items for each category of allocation/payment, including management, advisory, or similar fees and performance-based compensation. *Expenses*: All fees and expenses paid by the private fund during the quarter, with separate line items for each category of fee/expense, including but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses. *Offsets*: The amount of any offsets or rebates carried forward during the quarter.
Portfolio Investment Table	A table for the private fund that discloses the following in respect of each portfolio investment:

©2022 The Bureau of National Affairs, Inc.

	Fees/Compensation: All advisory, monitoring, closing, administration, closing, disposition, directors, trustees, or similar fees or payments paid allocated or paid to the adviser or any of its related persons by or attributable to such portfolio investment during the quarter. *Ownership*: The private fund's ownership percentage of each portfolio investment during the quarter; if the private fund does not have an ownership interest, list 0% with a brief description of the investment.
Performance	Illiquid Funds: the following performance measures must be disclosed, calculated without the impact of any fund-level subscription borrowing facilities: *Gross*: Internal rate of return (IRR) and multiple of invested capital (MOIC) for all investments calculated on a gross basis. *Net*: IRR and MOIC for all investments calculated on a net basis *Realized/Unrealized*: Gross IRR and MOIC separately calculated and displayed for realized and unrealized investments. *Contributions/Distributions/NAV*: A statement that sets forth all capital contributions and distributions of the private fund since inception, with the value and date of each inflow and outflow, and the net asset value of the fund as of the end of the quarter. Liquid Funds: Annual net total returns for each calendar year since inception. Average annual net total returns over the 1-, 5-, and 10-year calendar year periods. Cumulative net total return for the current calendar year, as of the end of the most recent calendar quarter.
Cross-References to Fund Organizational & Offering Documents	The quarterly statement must also include prominent disclosure of the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated and include cross-references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.

While most private fund advisers deliver quarterly statements to private fund investors detailing expenses, performance, etc., it is unlikely that these statements include specific line-item return and expense disclosures or explicit references to private fund documents regarding calculation methodology. In discussing these requirements, the SEC noted their belief that the calculation of IRR with the impact of fund-level subscription borrowing facilities could mislead investors, as such calculation would "artificially increase performance metrics."

Advisers may face significant cost burdens in updating quarterly statement reporting practices to reflect these new requirements, as proposed. Additionally, some advisers may consider some of the required information for these quarterly statements to be proprietary.

Annual Review of Compliance Policies

In addition to the private fund investor protections describe above, the proposed rules would also amend rule 206(4)-7 under the Advisers Act to require all registered investment advisers, including those that do not advise private funds to document the annual review of their compliance policies and procedures in writing. This is another portion of the proposal that is already followed by many RIAs, and there are reasonable arguments that such documentation is already required.

©2022 The Bureau of National Affairs, Inc.