Proskauer

SEC Proposes Advisers Act Reforms Focusing on Private Fund Investor Protections

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On February 9, 2022, the U.S. Securities and Exchange Commission (the "SEC") proposed new rules and amendments to existing rules (the "Proposed Rules") under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act") that would have notable practical implications for private fund advisers, in many cases, regardless of the adviser's registration status.

The Proposed Rules include prohibitions or mandates regarding certain practices and private fund terms that historically have been addressed through negotiations between advisers and private fund investors and/or disclosure of the adviser's practices to private fund investors. In particular, several of the proposals represent a significant deviation from the traditional paradigm of the Advisers Act as a disclosure-based regime with respect to conflicts of interest, prescribing and prohibiting specific actions by advisers in lieu of focusing on the quality of advisers' disclosures.

At a high level, the Proposed Rules include significant proposed requirements and restrictions for private fund advisers pertaining to, among other things, the following topics (each as discussed further below):

- ???quarterly statements to private fund investors;
- ???private fund financial statement audits;
- ???adviser-led secondaries transactions;
- ???prohibitions on certain adviser practices and activities;
- ???conditions to providing preferential treatment to private fund investors; and
- ???annual reviews under the Advisers Act's compliance program rule.

The Proposed Rules are the latest in a wave of recently proposed reforms in the private funds space.[1]

With the Proposed Rules, the SEC's stated goal is to enhance both the regulation of private fund advisers and the protection of private fund investors by increasing transparency, competition and efficiency.[2] In the 341-page proposing release accompanying the Proposed Rules, the SEC emphasized these goals and its focus on private fund adviser activities that it believes are contrary to such goals and the public interest, while also highlighting the increasingly important role private funds and their advisers play in the financial system, the broader economy and individuals' savings.[3] The proposing release contains a significant number of questions and requests for comment with respect to the Proposed Rules as well as certain additional proposals under consideration by the SEC. Notably, the Proposed Rules do not apply to separately managed accounts outside of the private funds context,[4] which raises the question of how that segment of the industry might be impacted.[5]

Timing and Applicability

Comments on the Proposed Rules are due by April 11, 2022 (*i.e.*, the 60th day after the Proposed Rules were published on the SEC's website) or the 30th day after the Proposed Rules are published in the Federal Register, whichever is later. While the Proposed Rules, if adopted, would provide a one-year transition period for compliance following each rule's effective date (which effective date would be 60 days after publication of such rule in the Federal Register), the Proposed Rules do not include a "grandfathering" provision, which would be significant if the Proposed Rules were to be adopted and deemed to apply to existing private funds (*i.e.*, as opposed to only contractual arrangements and practices entered into after the transition period has expired). To the extent a grandfathering concept is not ultimately included in the final rules, private fund advisers and investors should anticipate a comprehensive review of all existing contractual arrangements, which could potentially result in an unprecedented volume of modifications to the governing documents of existing private funds and a general "unwinding" of several commercial practices that have widely been considered market standard since the inception of the private funds industry. Such modifications to existing governing documents and practices would likely entail substantial cost and administrative burden to both private fund advisers and investors alike.

Overview

Quarterly Statements *(in scope: all SEC-registered investment advisers (RIAs) with private fund clients)*

The Proposed Rules would require RIAs to provide quarterly statements to private fund investors with detailed information on: (1) private fund fees and expenses by specific category; (2) compensation received by private fund advisers and related persons relating to the management of private funds (*e.g.*, management fees, carried interest and other performance compensation, and portfolio company remuneration) and any related management fee offsets; and (3) fund performance.

The proposed performance-related requirements would vary depending on whether the RIA determines the private fund is a liquid fund or an illiquid fund (*i.e.,* defined based on features that generally differentiate hedge and private equity funds). Fund performance for illiquid funds would be required to include gross and net internal rates of return and multiples of invested capital, computed without the impact of any fund-level subscription facilities. The quarterly statement would be in table format, required to include disclosure on how calculations were made (including cross-references to fund governing documents) and due within 45 days of the end of each quarter.

Key Open Question(s) to Consider:

- ???The proposing release indicated that RIAs would be required to list each specific category of expense as a separate line item, rather than be permitted to group fund expenses into "broad categories." It is unclear, however, from this proposal's description of expense "categories" precisely what level of an expenses breakdown is necessary (*e.g.*, whether legal expenses would need to be broken down between deal, organizational, operational, etc.).

Annual and Liquidating Audits of Private Funds *(in scope: all RIAs with private fund clients)*

Under the Proposed Rules, an RIA would be required to prepare and deliver annual financial statements in accordance with U.S. GAAP (or in the case of funds formed or with a manager with a principal place of business outside the U.S., substantially similar to GAAP with a reconciliation) for each private fund it advises and to obtain annual and liquidation audits of such financial statements. Accordingly, the Proposed Rules would effectively eliminate the ability of private fund advisers to avoid annual audits by choosing the alternative "surprise examination" approach to compliance under the Advisers Act custody rule (the "Custody Rule"). The audit must be performed by an auditor registered with the PCAOB and, in a deviation from existing annual audit requirements under the Custody Rule, the auditor must agree in writing with the adviser to inform the SEC directly if it issues a modified opinion or resigns or is dismissed from the engagement. The proposal does not specify the timing for delivery of the financial statements (other than "promptly" following completion of the audit), although the Custody Rule separately requires that audited financial statements be delivered within 120 days from fiscal year end (or 180 days for funds of funds).

Key Open Question(s) to Consider:

- ???As currently written, the proposed new audit rule would only apply to RIAs and private funds; for most RIAs to private funds who currently make use of GAAP-compliant audited financials for purposes of Custody Rule compliance, this would not result in any meaningful change in practice. However, the SEC in its proposing release asked for input as to: (1) whether the new rule and requirements should apply to *all* advisers to private funds, rather than just to RIAs; and (2) similarly, whether the new rule and requirements should also apply to all pooled investment vehicle clients of an adviser, rather than just in the context of those vehicles meeting the Advisers Act's definition of a private fund.

Adviser-Led Secondaries *(in scope: all RIAs with private fund clients)*

The Proposed Rules would mandate additional requirements for RIAs regarding "adviser-led"[6] secondary transactions with respect to any private fund. The adviser would be required to distribute, prior to the transaction's closing date, the following to the private fund's investors: (1) a fairness opinion from an independent opinion provider; and (2) a summary of any material business relationships the RIA or any of its related persons has or has had with the independent opinion provider within the past two years.

Key Open Question(s) to Consider:

- Similar to the recent SEC proposals with respect to Form PF, "adviser-led"secondary transactions would not be limited to GP-led continuation fund transactions, but would also include certain types of secondary transactions that have historically presented fewer conflicts of interest with respect to pricing, such as normal course tender offers and "LP stake" secondary transactions initiated by the sponsor. Moreover, there would be no exception to the fairness opinion requirement for (1) adviser-led transactions where pricing is established pursuant to a competitive auction presented to multiple secondary buyers, a concurrent acquisition by a third party strategic buyer or similar processes that are commonly used to establish fair pricing in the secondary industry or (2) adviser-led secondary transactions where investors are provided a status quo option to decline participation but remain invested on substantially the same terms as prior to the secondary transaction.

Prohibited Activities *(in scope: all advisers to private funds, regardless of registration status)*

The Proposed Rules notably include the following prohibitions on certain practices by all private fund advisers (whether or not registered):

- The Proposed Rules would prohibit charging certain fees and expenses, specifically (1) "accelerated monitoring fees" and other fees for services that are not provided, (2) fees and expenses associated with the examination or investigation of an adviser or its related persons by any governmental or regulatory authority and (3) regulatory or compliance fees and expenses of the adviser or its related persons. The prohibition on charging expenses relating to governmental or regulatory examinations or investigations is not limited to SEC examinations or investigations and there is no exception to the prohibition on charging regulatory or compliance fees and expenses (including registration or start-up expenses), including for first-time fund managers.[7]
- The Proposed Rules would prohibit using certain exculpatory and indemnification provisions to shield the adviser or provide for indemnification in a matter involving the adviser's negligence, including a breach of fiduciary duty.[8] As currently drafted, the Proposed Rules would prohibit all advisers from requiring any reimbursement or limitation on liability for actions arising from certain standards of conduct that have historically been commercially standard in the private funds industry, and generally not subject to material commercial objections from institutional and other investors.
- The Proposed Rules would prohibit reducing general partner clawbacks by the amount of any actual, potential or hypothetical taxes incurred by the adviser and its related persons.

- The Proposed Rules would prohibit borrowing or receiving any credit extension from a client, although it is unclear how the restriction on borrowings and extensions of credit may impact certain traditional terms of a private fund (*e.g.*, payment of placement fees and/or organizational expenses that are subject to management fee offset; tax distributions that are an advance against subsequent distributions; general partner "cashless" contribution obligations). The SEC has specifically asked for comment on whether tax distributions should be excluded from this prohibition.
- The Proposed Rules would prohibit non-pro rata allocations of certain deal-related expenses and fees among private funds or other clients of the adviser participating or proposing to participate in the same investment. The proposing release specifically highlights co-investments and generally would require co-investors that have executed a binding agreement to participate in a co-investment to be charged their pro-rata share of broken deal expenses. The SEC was silent on which party should bear a broken deal expense if a co-investor were commercially unwilling to bear such broken deal expenses, even where such co-investor is deemed to be needed to consummate the transaction.

Key Open Question(s) to Consider:

- In connection with the proposed prohibition against reducing adviser clawbacks by the amount of certain taxes, the SEC asked in its proposing release whether the new rules and regulations would achieve the intended effect of ensuring that investors receive their full share of profits (*e.g.*, would a prohibition on the use of deal-by-deal, American-style waterfalls be more effective?) and what other implications might the prohibition have on the industry (*e.g.*, attracting and retaining investment professionals).

Preferential Treatment *(in scope: all advisers to private funds, regardless of registration status)*

The SEC's Proposed Rules would prohibit preferential treatment of certain investors by all private fund advisers (whether or not registered) relating to redemptions and providing information regarding fund portfolio holdings or exposures if the adviser reasonably expects such preferential treatment to have a material, negative impact on other investors in that private fund or in a substantially similar pool of assets.

The Proposed Rules would also condition other types of preferential treatment afforded investors on the adviser's disclosing to prospective investors specific information regarding the preferential treatment and disclosing annually to existing investors any preferential treatment not previously disclosed.

The preferential treatment would need to be described specifically to convey its importance. The SEC indicated, for example, that if an adviser provides an investor with lower fee terms in exchange for a significantly higher investment than that made by others, the SEC does not believe that mere disclosure that some investors pay a lower fee is specific enough. Rather, the adviser must describe the lower fee terms, including the applicable rate (or range of rates), to satisfy the requirement. The SEC also indicated that an adviser could comply with the proposed disclosure requirements by providing copies of side letters (with identifying information regarding the other investors redacted) or could provide a written summary of the preferential terms provided to other investors in the same private fund, provided the summary specifically describes the preferential treatment. While some variation of this disclosure, typically on a more limited basis (*e.g.*, based on level of capital commitment), is common in the private equity space, it would deviate from current hedge fund market practices.

According to the SEC, whether a term is "preferential" is a matter of facts and circumstances. This part of the Proposed Rules, if adopted, would significantly impact private fund "side letter" practices.

Key Open Question(s) to Consider:

- One open question posed by the SEC in its proposing release is whether *all* preferential liquidity terms should be prohibited, rather than just those that the adviser reasonably expects to have a material, negative impact on other investors in that private fund or in a substantially similar pool of assets. The meaning of a "material, negative" impact is unclear.
- Another broader open question posed by the SEC in the proposing release is whether *all* preferential treatment should be prohibited instead of the currently proposed approach of prohibiting only certain types of preferential treatment.

Annual Review *(in scope: all RIAs, regardless of whether they have any private fund clients)*

The SEC's proposal would amend the compliance program rule under the Advisers Act to require all registered advisers (whether or not they advise private funds) to document the annual review of their compliance policies and procedures in writing.

Looking Ahead

The Proposed Rules summarized in the overview above, if adopted, would chart a course toward significant shifts in the ways that private funds and their advisers are regulated, as well as the terms of private funds and negotiations between advisers and private fund investors. The comments submitted to the SEC in the course of the next two months will shed additional light on how such shifts are being viewed by industry participants across the private funds space. Proskauer will continue to track these significant regulatory changes with a focus on the implications for various types of private funds and asset managers. Meanwhile, in addition to the Proposed Rules highlighted broadly in this alert, please note that the SEC separately proposed amendments to Form PF to require current reporting and amend reporting requirements for large private equity advisers and large liquidity fund advisers on January 26, 2022, and new cybersecurity risk management rules and amendments under the Advisers Act and the Investment Company Act of 1940, as amended, on February 9, 2022.[9] The proposed cybersecurity-related reforms would only apply to RIAs and the private funds they advise and would involve, among other new rules and mandates, a requirement to publicly disclose cybersecurity risks and significant cybersecurity incidents that occurred in the last two fiscal years in the RIA's Form ADV Part 2A brochures.

If you would like to discuss or have further questions on this client alert, please reach out to a member of your Proskauer team.

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[1] *See, e.g.,* Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, Release Nos. IA-5956; IC-34497 (proposed February 9, 2022); Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, Release No. IA-5950 (proposed January 26, 2022). These proposals are available on the SEC's website here and here.

[2] SEC Press Release 2022-19 (entitled "SEC Proposes to Enhance Private Fund Investor Protection").

[3] *See* Proposing Release at 8, 17 and 261 (available on the SEC's website here). Please also refer to the SEC's Fact Sheet regarding these Proposed Rules (available on the SEC's website here).

[4] *See* Proposing Release at 17 (explicitly carving out separately managed accounts from the scope of what the SEC intends for these proposed reforms to cover).

[5] The SEC defines a "private fund" as an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for section 3(c)(1) or 3(c)(7) of that Act. *See* Proposing Release at 7 n. 2.

[6] The SEC's proposal would define "adviser-led secondary transaction" to include any transaction initiated by the investment adviser or any of its related persons that offers private fund investors the choice to: (i) sell all or a portion of their interests in the private fund; or (ii) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. *See* Proposing Release at 330.

[7] This marks a departure from prior SEC practice, which until this point had focused on the clarity (or lack thereof) of pre-commitment disclosures to investors. The approach under the Proposed Rules would therefore eliminate freedom of contract with respect to such terms between an adviser and an investor.

[8] The Proposed Rules would prohibit exculpating or indemnifying an adviser for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to a private fund. *See* Proposing Release at 133, 150.

[9] *See supra* note 1.

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