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Conflicts of Interest: How High Will the Bar be Raised?

The Capital Commitment Blog on **May 3, 2022**

The SEC last month proposed rules under the Advisers Act indicating a dramatic shift in how the SEC intends to reduce conflicts of interest involving private fund managers and their investors. As we previously noted in the context of increased disclosure obligations, the SEC's recent approach previews a sea change redefining the relationship between private fund managers and their investors. For decades, the SEC has sought to address potential conflicts through a combination of disclosure and informed consent, in light of the sophisticated nature of private fund limited partners. However, the SEC's proposal now pivots from that approach, concluding that certain fund manager practices are inherently conflicted and therefore in some cases necessitate that the fund manager undertake specific actions, or in other cases must be flatly prohibited. As the SEC put it in their Proposing Release, "We have observed certain industry practices over the past decade that have persisted despite our enforcement actions and that disclosure alone will not adequately address."

The SEC's focus on conflicts of interest is nothing new, and is a perennial focus of the Division of Enforcement and Division of Examinations. Under the Advisers Act's antifraud provisions and related fiduciary obligations, investment advisers must "eliminate or at least expose through full and fair disclosure" all conflicts "which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested." For fund managers, any financial determination or allocation involving the manager and the client (*i.e.* the fund) has the potential to be seen as a conflict, requiring adequate disclosure and consent. Now however, the SEC is taking the position that there are certain conflicts that private fund investors cannot consent to, no matter how well-disclosed.

For example, the SEC's Proposed Rules contain requirements and prohibitions on the following:

1. Required: Quarterly reporting. The Proposed Rules would require all SEC-registered fund managers to provide quarterly reports to all investors of: (i) fund-

level adviser compensation, fees/expenses and offsets, broken down in detail and cross-referenced to the relevant sections in the fund's governing documents; (ii) portfolio investment-level adviser compensation, again broken down in detail on a per-investment basis and (iii) fund-level investment performance, on a standardized basis. The SEC's goal with this proposal is twofold: to provide sufficient transparency to permit investors to monitor and police the expenses they are bearing, and to provide an apples-to-apples basis of investment performance comparison for investors across different funds.

2. Required: Fairness opinions in adviser-led secondary transactions. The Proposed Rules would also require all SEC-registered fund managers to obtain a fairness opinion in all adviser-led secondary transactions (which would include most GP-led fund restructurings, as well as tender offers and other types of secondary transactions). The fund manager would also need to provide to all investors a list of all material business relationships between the fund manager and the opinion provider (and their respective affiliates).

3. Prohibited: Accelerated monitoring fees. The Proposed Rules would prohibit these and other fees for services that are not provided to a portfolio company. Historically, Enforcement has focused on whether the manager adequately disclosed that it could accelerate future monitoring fees.

4. Prohibited: Charging the fund for regulatory or compliance expenses. The Proposed Rules would also prohibit allocating any regulatory or compliance expenses of the adviser or its related persons to a fund. This prohibition is not limited to SEC investigations or examinations. It also would prohibit allocating any start-up and registration compliance expenses for first-time fund managers.

5. Prohibited: Seeking exculpation or indemnification for simple negligence (or worse). The Proposed Rules would also prohibit any fund manager from seeking exculpation or indemnification for negligence, recklessness, breach of fiduciary duty, willful misfeasance or bad faith, in providing services to a private fund.

6. Prohibited: Reducing GP clawbacks for taxes. The Proposed Rules would also prohibit reducing general partner clawbacks by the amount of any actual, potential or hypothetical taxes. This proposal cuts against settled and longstanding conventions across the private fund space.

7. Prohibited: Extensions of credit to the fund manager:The Proposed Rules would also prohibit borrowing or receiving any credit extension from a client, although it is unclear how the prohibition would affect typical advancement/offset terms of private funds that might be considered an extension of credit.

8. Prohibited: Non-pro rata allocation of deal-related expenses. The Proposed Rules would also prohibit non-pro rata allocations of deal-related expenses and fees

among funds and co-investment vehicles participating in the transaction. In particular, this proposal seeks to ensure that co-investors bear a pro rata share of broken deal expenses. Significantly, the SEC acknowledges that certain co-investors may commit to a deal but refuse to be contractually bound to bear any broken deal expenses, which would leave the manger itself as the only remaining party to bear such expenses.

9. Prohibited: Certain preferential treatment: The Proposed Rules would also prohibit all instances of preferential treatment for private fund investors regarding: (i) redemptions or other liquidity rights and (ii) information rights relating to the fund's portfolio, in each case to the extent the rights could have a material adverse impact on the other fund investors, and would prohibit other types of preferential treatment (*e.g*. fee terms) unless fully and specifically disclosed to all prospective investors and with annual updates. These provisions often appear in side letters requested by certain investors, which can be negotiated at the same time or even after other investors have already committed to the fund. Importantly, the SEC expects such disclosures to be made prior to investors' investment in the fund, which could pose significant logistical challenges to fund managers in advance of an initial closing given how fluid investor negotiations can often be in that context.

As we have noted, many of the foregoing proposals depart from prior SEC practice, which historically focused on the clarity (or lack thereof) of pre-commitment disclosures to investors. A number of these proposals also cut against longstanding commercial norms, limiting freedom of contract between advisers and investors no matter how sophisticated or well-represented those investors may be. If enacted, they would result in significant changes to how private fund managers operate their businesses and interact with their investors.

These proposals also serve as a clear indication of SEC exam and enforcement focus going forward, regardless of the form that the final rules take. The issues and practices that these proposals target have been a focus of the SEC's Division of Examination and Division of Enforcement for the past decade. This proposal therefore serves as an indication of where they are likely to focus their attention going forward.

For more information on the proposed SEC rules discussed in this posting, please request an invitation to access the recordings and materials from our most recent installments of *The Bottom Line: When "Private" Suddenly Feels More "Public". What do the Proposed Rules Really Mean for Private Funds? (Part I, for Venture Capital and Private Equity Advisers, and Part II, for Hedge Fund Advisers)*.

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