

Q&A

Proskauer»

The Bottom Line of the SEC's Proposed Private Fund Rules

On February 9, 2022, the U.S. Securities and Exchange Commission (the "SEC") proposed new rules and amendments to existing rules under the U.S. Investment Advisers Act of 1940, as amended, that would have notable practical implications for private funds advisers, in many cases regardless of the adviser's registration status. At a high level, the proposed rules include significant requirements and restrictions for private fund advisers pertaining to, among other things: quarterly statements to investors, adviser-led secondaries transactions and prohibitions on certain adviser practices and activities. Below, we have presented a collection of questions and answers exploring some of the issues raised by these proposals.

This document is intended as a complement to The Bottom Line's recent two-part series on the SEC's proposed rules. If you missed the series, please see the links at the end of this document to request an invitation for access to the recordings and the electronic versions of the materials.

Quarterly Statements to Investors

Fund-Level Disclosures: Fees, Expenses and Offsets

Q: In listing out the amounts paid to the adviser as compensation, would the table simply list the net amount of Management Fees actually charged (i.e., post-offset or reduction)?

A: *No, the table would need to list the amount of the unreduced management fee that would have been payable without the offset or reduction, and then separately list the amount of the offset or reduction (discussed below).¹*

Q: In disclosing Fund-level expenses, how should we think about disclosing fees for services performed by the adviser's back-office personnel, if the Fund is authorized to bear such expenses (e.g., administrative, accounting legal or other services that are performed in-house by the adviser's employees and that the LPA expressly includes in the "Fund Expense" definition)?

A: *Those would be reported as "Adviser Compensation", not "Fund Fees and Expenses."²*

Q: In listing the amount of offsets, rebates and waivers, would "waivers" include tax-related "management fee waivers", where the adviser waives receipt of a specified portion of management fees and receives a correspondingly-increased share of the Fund's profits qualifying as a "profits interest" under IRS guidelines?

A: *Yes, it would. However, the SEC has requested comments on whether it should provide further clarity or guidance on this point, so this may change.*

Unparalleled
insight into market
trends, terms and
conditions

For information on our
market leading private funds
and hedge fund practices,
please visit:

[Proskauer.com](https://www.proskauer.com)

Proskauer Rose LLP | Attorney Advertising

¹ See Proposed Rule 211(h)(1)-2(b).

² See Proposed Rule 211(h)(1)-2(b)(1) ("all amounts allocated or paid to the investment adviser").

Investment-Level Disclosures: Private Fund Manager Revenues

Q: If a Fund owns less than 100% of a portfolio investment, should the adviser report 100% of fees received from that portfolio company, or just the portion of those fees attributable to the Fund's ownership percentage of the portfolio investment?

A: *Only the portion of those fees that is attributable to the Fund's investment. As explained by the SEC, the amount of such fees that would be reported to the Fund's investors in the quarterly report "would not reflect the portion attributable to any other person's interest in the covered portfolio investment. For example, if the private fund and another person co-invested in the same portfolio investment and the portfolio investment paid the private fund's adviser a monitoring fee, the table would only list the total dollar amount of the monitoring fee attributable to the fund's interest. We believe this approach is appropriate because it would reflect the amount borne by the fund and, by extension, the investors."*

Q: In disclosing the Fund's percentage ownership of a given portfolio investment, how should we reflect an interest that does not convert into a straightforward percentage ownership interest of an issuer, such as preferred equity or debt?

A: *The SEC proposes listing such interests as a 0% ownership interest, with an accompanying description of the interest held. But the SEC is also requesting comments on this proposal, so this may change.*

Investment Performance

Q: In calculating Fund-level gross and net investment performance, how does one account for the fact that some investors bear no management fees and/or carried interest, or management fees or carried interest determined at different rates than the rates generally applicable to other investors?

A: *As currently proposed, performance would be calculated at the Fund-level, which would effectively use the weighted-average fee and carry levels across all investors. However, the SEC has requested comments on whether a different approach should be used, so this may change.*

Q: Under the Proposed Rules, performance information should exclude the impact of any Fund-level subscription facility, as if the Fund called investor capital, rather than drawing down on the facility. Could we also present the Fund's performance including the effect of the Fund's subscription facility?

A: *Yes, the Proposed Rules would allow you to present levered returns alongside the unlevered returns.*

Q: Could we simply include the new performance table in an appendix or other ancillary document, rather than in our usual investor update materials?

A: *Generally no. The required performance table must be presented with at least equal prominence alongside other performance metrics.*

Adviser-Led Secondary Transaction Requirements

Q: What about cross-fund sales, where one fund (e.g., Fund III) sells a portfolio investment to a successor fund (e.g., Fund V)? Would those be picked up as "secondary transactions"?

A: *Not under the current proposal. However, the SEC has asked for comments on whether such cross-sales should be picked up here, so this may change.*

Q: One of our funds is past the end of its investment period. The fund's LPA obligates the GP to attempt to liquidate the fund's assets. We have arranged for a third-party buyer to buy one of the fund's largest assets at an incredible valuation – this will result in a 10X gross MOIC for the fund; this would make it among our highest-performing investments ever, and our investors will be thrilled. The buyer has asked us to manage the position for them going-forward given our familiarity and success with this asset, so we will be establishing a new vehicle to hold the investment, in return for a Management Fee and a Carried Interest. And we're offering existing investors the chance to roll in on the same terms, because some of them seemed very interested in continuing their stake and participating in the future upside potential. This isn't picked up by the Proposed Rules, is it?

A: *Yes, this transaction would qualify as an "adviser-led secondary transaction"³. The fact that the investors would receive a 10X MOIC would not change the answer. Nor, in the SEC's eyes, would a 10X MOIC lessen the conflict. For example, while a 10X MOIC seems like a highly favorable result, a fairness opinion provider would perform its own valuation analysis, and might conclude that an even higher sale price (e.g., one that would result in a 15X MOIC) would be fairer.*

Annual Compliance Reviews: Written Documentation

Q: We have previously worked with our outside law firm in connection with our annual reviews. Our law firm would retain a compliance consulting firm to perform the review. A benefit of doing it in this way is that, if the review uncovered problems, then the communications with the law firm and the consultant might be protectable by attorney-client privilege. However, the SEC seems to be critical of this practice, noting in its Proposing Release that "Commission staff has observed claims of the attorney-client privilege, the work-product doctrine, or other similar protections over required records, including any records documenting the annual review under the compliance rule, based on reliance on attorneys working for the adviser in-house or the engagement of law firms and other service providers (e.g., compliance consultants) through law firms."

³ See Proposed Rule 211(h)(1)-1.

Would this Rule do away with attorney-client privilege on communications relating to the annual review?

*A: This proposal would not alter existing protections afforded by attorney-client privilege relating to those communications. What this Rule would change is the requirement to **document** the annual review. Currently, Rule 204-2 (the Books and Records Rule) does not require that annual reviews be documented, although it does require that advisers maintain any records that they do choose to create or receive that document that review. The SEC seems to be critical of the practice of advisers not maintaining any documentation of the annual review, where the law firm might be the only party to receive documentation produced by the compliance consultant, since that deprives the SEC of the opportunity to verify the sufficiency of that review. By obligating advisers to affirmatively create or obtain such a report, the Rule would likely force many RIAs to think tactically about what the annual review report contains, taking care to keep privileged contents out of the report itself where possible. Such decisions will likely be difficult unless the SEC provides more guidance on the minimum required elements of such documentation, although the SEC has requested comments on whether it should specify the required elements, so this may change.*

Prohibited Activities

Prohibition on Charging Adviser-Related Compliance Fees and Expenses

Q: Could compliance with this new Rule be charged to the Fund?

A: No. The SEC believes that the adviser's ongoing regulatory and compliance fees and expenses are "a cost of being an investment adviser [that] should not be passed on to private fund investors."

Prohibition on Non-Pro Rata Allocations of Expenses Relating to a Given Portfolio Investment

Q: What if a co-investor commits to the deal but refuses to contractually agree to bear any broken deal expenses? What happens if the deal then breaks? Who is supposed to bear that co-investor's share of the broken deal expenses?

A: As currently proposed, the adviser could not allocate to the Fund any portion that that co-investor would have borne. Likely the only remaining solution would be for the adviser to bear the expense. However, the SEC has asked for comments on whether a different result would be more appropriate. If the SEC adopts the rule as proposed, fund advisers would likely no longer agree to any co-investment arrangements in which the co-investor refuses to bear broken-deal expenses. Another issue is whether pre-existing co-investment arrangements will be grandfathered, although no grandfathering is currently proposed.

Prohibitions Relating to Certain Preferential Terms

Q: We have agreed to reduced management fees with certain investors, in some cases because they invested at the initial closing and in other cases because they committed to invest very significant amounts of capital. Would we still have to disclose these terms to investors coming in at later closings? Can we simply disclose that we have agreed to lower fees with certain investors?

A: The SEC expects the disclosure to be detailed, and to disclose the actual lower fee rate (or range of rates, if there was a range), not simply describing it as "lower."

Q: What about excuse or exclusion rights, where certain investors (e.g., sovereign wealth funds) are granted the right to be excluded from participating in certain types of investments, such as in companies deriving a certain percentage of their revenues from alcohol or tobacco products, firearms and the like?

A: Yes, the SEC calls those examples out as well, and believes that they should be included in the disclosures to investors given their potential impact on the other investors who would have a greater participation in those investments as a result.



Legal & Business Insights for Asset Managers

The Bottom Line

If you missed it, please visit our two-part Bottom Line series where Proskauer and special guests take part in an in-depth discussion of what the SEC's proposed rules really mean for sponsors of Private Equity Funds, Venture Capital Funds, Credit Funds and Hedge Funds.

When "Private" Suddenly Feels More "Public". What do the SEC's Proposed Rules Really Mean for Private Funds?

Please register here:

[Part I: Applicability for Private Equity, Venture Capital and Other Close-End Private Fund Advisers](#)

[Part II: Applicability for Hedge Fund Advisers](#)