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Disclosure

The Continuing Trend – and Potential Ramifications – of Increasing Private Fund Manager Obligations

By Joshua M. Newville, Robert H. Sutton and Adam L. Deming, *Proskauer Rose LLP*

In February 2022, the SEC proposed new rules (Proposal) under the Investment Advisers Act of 1940 (Advisers Act) that, if implemented, would be the most significant enhancement of disclosure obligations for private fund managers since the Dodd-Frank Act. Citing investor protection and transparency concerns for LPs as investors, the Proposal signals the Commission's belief that existing general disclosure obligations under the Advisers Act are insufficient and that additional tools are needed in the fund manager enforcement and examination toolbox.

This article analyzes the SEC's shifting stance over time toward fund manager disclosure obligations; relevant provisions of the Proposal marking that shift; other recent forms of SEC rulemaking and guidance that evidence the agency's new stance; and potential ways the SEC's evolving approach could manifest in its enforcement efforts.

See our three-part series on the Proposal: "Overview of the Proposal and the Importance of Industry Comments" (May 24, 2022); "General Observations" (May 31, 2022); and "Rule-Specific Concerns and Next Steps" (Jun. 7, 2022).

Shift in Approach

The SEC's primary tool for regulating and enforcing private fund manager conduct has been the general disclosure obligations under Section 206 and Rule 206(4)-8 of the Advisers Act. That approach was influenced by a belief that, because private fund investors are composed of sophisticated institutions and high net worth individuals, they (or their advisers) would be competent enough to understand the import of what was disclosed to them. Further, it suggests the SEC believed private fund investors would also be assertive and resourceful enough to obtain and analyze the information needed to make good investment decisions, and accordingly, more specific requirements were not needed.

SEC Chair Gary Gensler has indicated a clear departure from the view that private fund investors need less protection from granular rules, observing that investors in private funds are often retirement plans, non-profits or university endowments composed of "teachers, firefighters, municipal workers, students, and professors." Instead, Gensler and others at the SEC – perhaps motivated by a perceived pattern of misleading disclosures and other misconduct – appear to believe that general disclosure obligations and a duty to not mislead investors inadequately protect those investors. One sentence in the Proposal sums it up: "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."

For coverage of Gensler's remarks, see "Gensler Outlines Private Fund Regulatory Agenda and Aggressive Areas of SEC Focus" (Dec. 7, 2021). See also "Practical Insights on Five Problematic GP/LP Dynamics Identified by SEC Chair Gensler" (Feb. 1, 2022).

The shift to a more granular, prescriptive rulemaking framework did not originate with Gensler. Under the prior administration, for example, the Commission approved amendments to the Advertising Rule (now renamed the Marketing Rule) under the Advisers Act. Enforcement of the previous Advertising Rule was based on previous SEC no-action letters that often relied on the SEC staff's application of general disclosure obligations to the specific facts at issue in those cases, thereby allowing for different approaches where an adviser's facts differed. By contrast, the amended Marketing Rule contains many specific, prescriptive requirements that must be applied in all circumstances, regardless of the context and any accompanying disclosures that might seem to address the rule's underlying concerns.

See "Eleven 'Top of Mind' Questions and Misconceptions Surrounding the New Marketing Rule" (Mar. 22, 2022); as well as our two-part series: "What Constitutes an 'Advertisement' and How to Adhere to Principles-Based Standards" (Mar. 23, 2021); and "Disclosures in Non-Standard Calculations and Requirements When Using Promoters" (Mar. 30, 2021).

The trend toward more prescriptive rulemaking has decidedly accelerated, however, under Gensler, who, not long after stepping into his new role, signaled his intent to extend the reach of the federal securities laws further into the operation of private funds than ever before. Gensler justified those efforts by spotlighting the SEC's responsibility to protect investors; facilitate capital formation; and maintain fair, orderly and efficient markets. Under those pretenses, Gensler instructed the SEC staff to consider tightening regulations around private fund practices, such as increasing transparency around fees and expenses; evaluating hedge clauses; and limiting the use of side letters. Those efforts culminated in the Proposal.

Aim of Enhanced Private Fund Investor Protection

Many of the Proposal's reforms depart from prior SEC practice, which historically focused on the clarity (or lack thereof) of pre-commitment disclosures to private fund investors. In contrast, the Proposal effectively deems certain practices to be material per se and therefore in some cases must be accompanied by specific disclosures. In other cases, certain practices must be prohibited outright regardless of how well disclosed they are or how clearly investors may have consented to them. Further, the requirements are likely to add a significant amount of administrative cost, burden and strain on private fund managers.

Prohibited Activities

If enacted as written, the Proposal would prohibit certain existing practices, including:

- collecting accelerated monitoring fees or other fees for services not performed;
- seeking exculpation or indemnification for acts of simple negligence;
- reducing any GP clawback by the amount of any taxes owed or potentially owed;
- causing investment-related expenses to be allocated across participating funds in a non-pro rata manner;
- borrowing from or lending to a private fund client; and
- causing a fund client to bear expenses associated with an examination or investigation of the adviser.

See our two-part series: "SEC's Proposed Amendments to Form PF and Advisers Act Introduce Uncertainty, Increase Burden on Compliance Staff" (Mar. 15, 2022); and "Quarterly Reporting Requirements and Prescriptive Prohibited Activities in the SEC's Proposed Amendments to the Advisers Act" (Mar. 22, 2022).

Enhanced Disclosure Requirements

The Proposal would also impose detailed disclosure obligations and other specific requirements on private fund advisers. The following are notable examples of reformed disclosure requirements under the Proposal.

Quarterly Reporting

The Proposal would require all SEC-registered fund managers to provide quarterly reports to all investors of:

1. 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;
2. portfolio investment-level adviser compensation, again broken down in detail on a per-investment basis; and
3. fund-level investment performance, on a standardized basis.

The SEC's goal 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.

Fairness Opinions in Adviser-Led Secondary Transactions

The Proposal would 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, 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, the opinion provider and their respective affiliates.

See our two-part series on the evolution and future of GP-led restructurings: "Transaction Structuring Trends and Conflicts of Interest Management" (Jun. 2, 2020); and "Key Considerations When Negotiating Fees, Expenses and RWI" (Jun. 9, 2020).

Preferential Treatment of Fund Investors

The Proposal would prohibit all instances of preferential treatment for private fund investors regarding redemptions or other liquidity rights, as well as information rights relating to the fund's portfolio. In each case, the preferential treatment is prohibited to the extent the rights could have a material adverse impact on the other fund investors. Further, the prohibitions extend to other types of preferential treatment (*e.g.*, fee terms) unless fully and specifically disclosed to all prospective investors and with annual updates.

The types of provisions targeted by that prohibition 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 a fund. Importantly, the SEC expects those disclosures to be made before investors invest in a fund, which could pose significant logistical challenges to fund managers approaching an initial closing given how fluid investor negotiations can often be in that context.

See our two-part series: "Complications of Using Standard Form Provisions and Managing Administrative Burdens of Side Letters" (Jun. 29, 2021); and "Trends in Contentious Terms in Side-Letter Negotiations, Including MFNs and ESG Considerations" (Jul. 13, 2021).

Additional Disclosure Developments Affecting Private Fund Managers

The Commission is also actively advancing its agenda through additional rulemaking and guidance.

In January 2022, the Commission voted to propose amendments to Form PF that would, among other things:

- lower the reporting threshold for large PE advisers from $2 billion to $1.5 billion; and

- require rapid reporting – within one business day – of certain events that the Commission believes indicate significant financial stress at a fund.

The Commission's press release touted the amendments to Form PF as "bolster[ing] the Commission's regulatory oversight of private fund advisors and its investor protection efforts in light of the growth of the private fund industry."

See our two-part series on the proposed Form PF amendments: "Require More PE Sponsors to File and One-Business-Day Reporting Criteria" (Feb. 22, 2022); and "Practical Impact on PE Sponsors and Reasons for Industry Backlash" (Mar. 1, 2022).

In February 2022, the Commission also proposed significant amendments to Section 13(d) reporting obligations, which would shorten the filing deadlines for initial and amended Schedules 13D and 13G. PE fund managers should note that the amendments would expand the interpretation of a "group" under Schedule 13D and create a lower threshold for establishing such a group – essentially focusing on concerted actions by separate firms, rather than a formal or informal agreement. That may cause difficulties for PE firms seeking to acquire public companies.

In May 2022, the Commission also proposed rules and amendments that would require advisers employing environmental, social and governance (ESG) strategies to report additional information about those strategies to the SEC and provide additional, more detailed disclosures to clients. The proposed rules would apply to all investment advisers – whether SEC-registered or exempt reporting advisers – that merely "consider" ESG factors as part of one or more significant investment strategies.

See our two-part series on the SEC's proposed ESG rules: "Nuanced Concerns About Three ESG Categories and Other Form ADV Requirements" (Aug. 23, 2022); and "Forecasting the Private Fund Industry's Response and Offering Compliance Tips" (Aug. 30, 2022).

In January 2022, the SEC's Division of Examinations issued a risk alert providing observations from examinations of private fund advisers, including:

- deficiencies for conduct inconsistent with prior material disclosures; and
- insufficient fund disclosures regarding performance, marketing and hedge clauses.

See our two-part series on the risk alert: "Takeaways on Performance Advertising, Hedge Clauses and Side Letter Management" (Mar. 22, 2022); and "Lessons on Avoiding Disclosure Compliance Failures and Enhancing Diligence Efforts" (Mar. 29, 2022).

Implications for SEC Enforcement

There are also signs of a more rigorous SEC enforcement regime relating to fund manager disclosures. The Proposal would elevate certain disclosures previously analyzed under a materiality standard to ones that would essentially give rise to enforceable violations, notwithstanding materiality.

In brief, it is much easier for the SEC to bring claims based on non-compliance with bright-line rules than with more nebulous or subjective materiality standards.

Although the SEC cannot yet benefit from the Proposal's bright-line specificity, it continues to actively pursue perceived wrongdoing in the area through a series of enforcement cases in 2022 focused on disclosures to private fund investors. For example, the SEC brought a case against a venture capital adviser for failing to adequately disclose its fee billing practices. The SEC also reached an enforcement settlement with a PE fund manager for failing to disclose that it had allocated a disproportionate share of deal expenses to a fund it advised instead of to co-investors in the deal.

See "SEC Sanctions Adviser for Inequitable Allocation of Deal Expenses Between Its PE Fund and Co-Investors" (Jul. 26, 2022); and "SEC Sanctions Adviser for Misleading '2 and 20' Fee Claims and Improper Inter-Fund Loan Practices" (Apr. 5, 2022).

In addition, earlier this year the Commission entered into a settlement order with a wealth management firm for disclosure violations. Specifically, the SEC highlighted the firm's use of a hedge clause that contained relatively standard language disclaiming certain causes of action against the adviser. The SEC found that the hedge clause violated Section 206(2) of the Advisers Act, which protects prospective clients from fraudulent or misleading practices. Claims such as those would surely be even easier to bring once the rules' requirements become more specific via the Proposal.

Conclusion

The SEC's new proposals serve as a clear indication of the SEC's approach to regulating the private fund sector going forward – from rulemaking to examination and enforcement efforts – regardless of the form the final rules take. The issues and practices the proposals target have been a focus of the SEC for the past decade, but the SEC's approach has evolved. As a result, private fund managers will likely face additional disclosure and administrative burdens; increasing limitations on their actions; and a regulator armed with more tools to pursue streamlined enforcement.

Joshua M. Newville is a partner in Proskauer's New York office. He handles securities litigation, enforcement and regulatory matters, representing corporations and senior executives in civil and criminal investigations. In addition, he advises registered investment advisers and private fund managers on regulatory compliance; SEC exams; material nonpublic information and insider trading issues; and related risks.

Robert H. Sutton is a partner in Proskauer's New York office. He counsels fund managers and advisers of private funds on regulatory matters, as well as regulatory issues related to the formation and operation of PE, credit, real estate, infrastructure, hedge and other private funds.

Adam Deming is an associate in Proskauer's Boston office. He focuses on complex commercial litigation in federal and state courts, covering a broad spectrum of business disputes touching on corporate governance, fiduciary obligations, financial services, securities and insolvency. He has also represented

clients in appeals spanning various areas, including consumer products, life sciences, bankruptcy, labor relations, patent and constitutional law.