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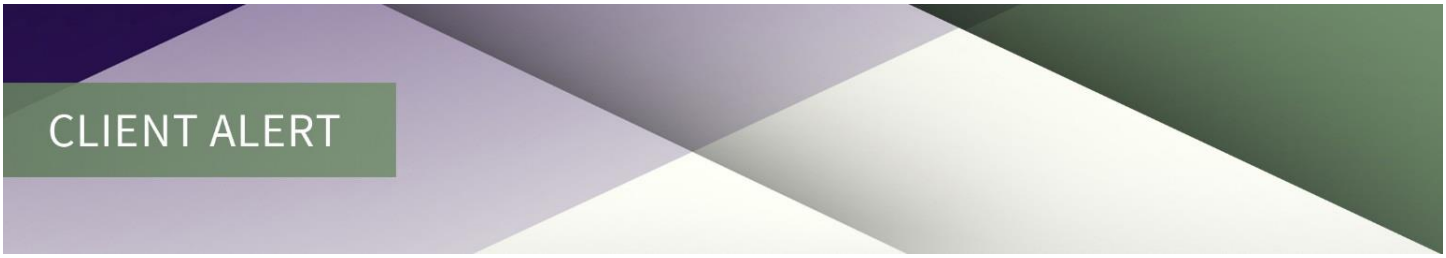

SEC Proposes Significant Rule Changes for Private Fund Advisers

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On February 9, 2022, the Securities and Exchange Commission ("SEC") voted 3 to 1 to propose five new rules (the "Proposed Rules") under the Investment Advisers Act of 1940 (the "Advisers Act") imposing significant new reporting requirements on registered private fund advisers, requiring annual audited financial statements for private funds, mandating fairness opinions for adviser-led secondary transactions, prohibiting certain fee and other arrangements for all advisers to private funds, and requiring all registered investment advisers to document their annual compliance review in writing.[1] Finally, the SEC proposes amendments to Rule 204-2 under the Advisers Act to impose recordkeeping requirements related to the Proposed Rules. Each of those proposals is described in more detail below.

A. Quarterly Statements

Proposed Rule 211(h)(1)-2 would require registered advisers that manage private funds to distribute a quarterly statement to the investors in those funds that describes in detail:

(i) all fees and expenses paid by the private fund during the reporting period;

(ii) fees and expenses paid by underlying portfolio investments to the adviser and its related persons; and

[1] See *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Advisers Act Release No. 5955 (Feb. 9, 2022) (the "Proposing Release"), available here.

(iii) performance information based on standardized metrics that differ based on whether the adviser classifies the private fund as a liquid or illiquid fund (as defined below).

As proposed, only fund-level information would be required.[2] Private fund advisers would not be required to provide personalized account statements showing each individual investor's fees, expenses, and performance. The SEC notes that the quarterly statement is necessary to improve the quality of information provided to private fund investors, allowing them to assess and improve the comparability of their private fund investments. The specific statement requirements include the following:

(i) Fees and Expenses Paid by the Private Fund

The Proposed Rule would require private fund advisers to disclose the following information to investors in a table format:

(i) "Adviser Compensation": A detailed accounting of all compensation, fees, and other amounts[3] paid to the adviser or any of its related persons[4] by, or allocated to, the private fund during the reporting period;

(ii) "Fund Expenses": A detailed accounting of all fees and expenses paid by the private fund during the reporting period, other than Adviser Compensation; and

(iii) The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons.[5]

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2 Proposed Rule 211(h)(1)-2(b).

3 Proposed Rule 211(h)(1)-2(b)(1) is designed to capture all compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons by the fund, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation.

4 Proposed Rule 211(h)(1)-1 defines "related persons" to include: (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser. Proposed Rule 211(h)(1)-1 defines "control" consistently with Form ADV as "the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise."

5 Proposed Rule 211(h)(1)-2(b)(3) would require advisers to disclose adviser compensation and fund expenses in the fund table both before and after the application of any offsets, rebates, or waivers. Specifically, the Proposed Rule would require an adviser to present the dollar amount of each category of adviser compensation or fund expense before and after any such reduction for the reporting period. In addition, the Proposed Rule would require advisers to disclose the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future adviser compensation.

The Proposed Rule is designed to capture all fund fees and expenses paid during the reporting period, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses. For example, if a fund paid insurance premiums, administrator expenses, and audit fees during the reporting period, a general reference to "fund expenses" would not satisfy the detailed accounting requirement. Instead, an adviser would be required to separately list each specific category of expense and the corresponding dollar amount.

To the extent a Fund Expense could also be characterized as Adviser Compensation, the Proposed Rule would require advisers to disclose such payment or allocation in the quarterly statement as Adviser Compensation, not a Fund Expense. For example, certain private funds may engage the adviser or its related persons to provide services to the fund, such as consulting, legal, or back-office services. An adviser would disclose any compensation, fees, or other amounts allocated or paid by the fund for such services as part of the detailed accounting of Adviser Compensation.

The Proposed Rule would require each quarterly statement to include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated. This would generally have the effect of requiring advisers to describe, for example, the structure of, and the method used to determine, any performance-based compensation set out in the statement (*e.g.*, the distribution waterfall, if applicable) and the criteria on which each type of compensation is based (*e.g.*, whether compensation is fixed, based on performance over a certain period, or based on the value of the fund's assets). The Proposed Rule would also require cross references to the relevant sections of the private fund's organizational and offering documents that set out the calculation methodology.

(ii) Fees and Expenses Paid by Covered Portfolio Investments to the Adviser

For any "covered portfolio investment," the Proposed Rule would require advisers to disclose in a single table in the quarterly statement:

(i) A detailed accounting of all compensation allocated to, or paid by, each covered portfolio investment during the reporting period; and

(ii) The private fund's ownership percentage of each covered portfolio investment as of the end of the reporting period along with a brief description of the fund's investment in the covered portfolio investment.[6]

The Proposed Rule[7] defines "portfolio investment" as any entity or issuer in which the private fund has invested directly or indirectly. This captures any entity or issuer in which the private fund holds an investment, including through holding

[6] The adviser would be required to determine the fund's ownership percentage as of the end of the reporting period. If the fund does not have an ownership interest in the covered portfolio investment, for example, if the fund has sold or completely written off its ownership interest in the covered portfolio investment during the reporting period, the adviser would be required to list zero percent as the fund's ownership percentage.

[7] *See* Proposed Rule 211(h)(1)-1.

companies, subsidiaries, acquisition vehicles, special purpose vehicles, and other vehicles through which investments are made or otherwise held by the private fund. As proposed, the definition could capture more than one entity or issuer with respect to any single investment made by a private fund. A "covered portfolio investment" is any "portfolio investment" that paid the investment adviser or its related persons compensation or to which such compensation was allocated during the reporting period.

The Proposed Rule[8] would require an adviser to consolidate the reporting for substantially similar pools of assets to the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading (*e.g.*, consolidated reporting for a master-feeder structure).

The Proposed Rule specifies that the accounting should have separate line items for each category of payment that reflect the total dollar amount attributable to that category, including origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments by the covered portfolio investment to the investment adviser or any of its related persons. An adviser would be required to list the amount of portfolio investment compensation allocated or paid with respect to each covered portfolio investment both before and after the application of any offsets, rebates, or waivers.

(iii) Performance Information of the Private Fund

The Proposed Rule[9] would require an adviser to include standardized fund performance information in each quarterly statement provided to fund investors. The disclosure requirements depend on whether the private fund is categorized as a "liquid fund" or an "illiquid fund."

The Proposed Rule[10] defines an "illiquid fund" as a private fund that: (i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor's request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments. The Proposed Rule[11] defines a "liquid fund" as any private fund that is not an illiquid fund.

8 Proposed Rule 211(h)(1)-2(f).

9 Proposed Rule 211(h)(1)-2(e).

10 *See* Proposed Rule 211(h)(1)-1.

11 *See* Proposed Rule 211(h)(1)-1.

For illiquid private funds,[12] an adviser would be required to disclose the following performance measures in the quarterly statement, shown since inception of the illiquid fund and through the end of the quarter covered by the quarterly statement, and computed *without* the impact of any fund-level subscription facilities:[13]

(i) Gross internal rate of return[14] and gross multiple of invested capital[15] for the illiquid fund;

(ii) Net internal rate of return and net multiple of invested capital for the illiquid fund; and

(iii) Gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.[16]

For illiquid private funds, an adviser would also be required to provide investors with a "statement of contributions and distributions," which must include:

(iv) All capital inflows the private fund received from investors and all capital outflows the private fund distributed to investors since the private fund's inception, with the value and date of each inflow and outflow; and

(v) The net asset value of the private fund as of the end of the reporting period covered by the quarterly statement.

For liquid private funds,[17] an adviser would be required to disclose the liquid fund's annual net total returns for each calendar year since the fund's inception. In addition, the adviser would be required to show the liquid fund's average annual net total returns over the one-, five-, and ten- calendar year periods. Finally, the adviser would be required to

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12 Proposed Rule 211(h)(1)-2(e)(2)(b).

13 The Proposed Rule would require advisers to calculate performance measures for each illiquid fund as if the private fund called investor capital, rather than drawing down on fund-level subscription facilities. Proposed Rule 211(h)(1)-1 defines "fund-level subscription facilities" as any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines, or other indebtedness incurred by the private fund that is secured by the unfunded capital commitments of the private fund's investors. The SEC notes that an adviser showing performance with the impact of subscription facilities could mislead investors because that method of calculation would artificially increase performance metrics.

14 Proposed Rule 211(h)(1)-1 defines "internal rate of return" as the discount rate that causes the net present value of all cash flows throughout the life of the private fund to be equal to zero.

15 Proposed Rule 211(h)(1)-1 defines "multiple of invested capital" as (i) the sum of: (A) the unrealized value of the illiquid fund; and (B) the value of all distributions made by the illiquid fund; (ii) divided by the total capital contributed to the illiquid fund by its investors.

16 Net returns for the separate realized and unrealized portions of an illiquid fund's portfolio are not required because the SEC acknowledges that calculating these net returns could involve complex and potentially subjective assumptions regarding the allocation of fund-level fees and expenses.

17 Proposed Rule 211(h)(1)-2(e)(2)(a).

show the liquid fund's cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.

To the extent quarter-end numbers are not available at the time of distribution of the quarterly statement, an adviser would be required to include performance measures through the most recent practicable date, which the Proposing Release indicates would be through the end of the quarter immediately preceding the quarter covered by the quarterly statement.

The Proposed Rule would require an adviser to display the different categories of required performance information with equal prominence and to include prominent disclosure of the criteria used and assumptions made in calculating the performance.

An adviser would remain free to include other performance metrics in the quarterly statement as long as the quarterly statement presents the performance metrics prescribed by the Proposed Rule and complies with the other requirements in the Proposed Rule. Although the quarterly statement required by the Proposed Rule would not be an "advertisement" under Rule 206(4)-1 under the Advisers Act (the "Marketing Rule"),[18] an adviser that offers new or additional investment advisory services with regard to securities in the quarterly statement would need to consider whether such information would be subject to the Marketing Rule. The quarterly statement would also be subject to the anti-fraud provisions of the Federal securities laws.[19]

Timing of Quarterly Statement Distributions

Proposed Rule 211(h)(1)-2 would require the private fund adviser to distribute the quarterly statement to the private fund's investors within 45 days after each calendar quarter end, unless a quarterly statement that complies with the Proposed Rule is prepared and distributed by another person. For a newly formed private fund, the Proposed Rule would require a quarterly statement to be prepared and distributed beginning after the fund's second full calendar quarter of generating operating results.

B. Annual Audited Financial Statements

Proposed Rule 206(4)-10 would require registered advisers that manage private funds to obtain annual financial statement audits from independent public accountants for the private funds they advise. A liquidation audit also would be required. As a practical matter, most private fund advisers already largely follow the approach mandated by the Proposed Rule to comply with the requirements of Rule 206(4)-2 under the Advisers Act (the "Custody Rule").

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[18] Proposing Release at 58.

[19] *See, e.g.*, Section 206 of the Advisers Act, Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934, to the extent applicable.

The Proposed Rule[20] would require a fund's audited financial statements to be distributed to current investors "promptly" after the completion of the audit. The SEC notes that a 120-day time period is generally appropriate to allow for the delivery of audited financial statements to investors, but the SEC has proposed that the financial statements be distributed "promptly" rather than by a specific deadline so as to provide some timing flexibility. For example, the Proposing Release indicates that preparing audited financial statements in some arrangements, such as fund of funds arrangements, might require reliance on third parties, which could cause an adviser to fail to meet a specific distribution timing requirement regardless of actions it takes to meet such a requirement.[21]

The Proposed Rule would require the accountant performing a private fund audit to meet the standards of independence described in Rule 2-01(b) and (c) of Regulation S-X, and generally would require the audited financial statements to be prepared in accordance with U.S. GAAP. Financial statements of private funds organized under non-U.S. law, or that have a general partner or other manager with a principal place of business outside the U.S., would be required to contain information substantially similar to statements prepared in accordance with U.S. GAAP and any material differences would be required to be reconciled to U.S. GAAP.[22]

The Proposed Rule[23] would require an adviser to enter into, or cause the private fund to enter into, a written agreement with the independent public accountant performing the audit to notify the SEC (i) promptly upon issuing an audit report to the private fund that contains a modified opinion and (ii) 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. Notably, the Custody Rule does not include this SEC notification requirement for an adviser that relies on the fund audit provision to satisfy the surprise examination requirement. This notification would be provided directly to the SEC's Division of Examinations.

For a fund that the adviser does not control and that is neither controlled by nor under common control with the adviser (e.g., where an unaffiliated sub-adviser advises the fund), an adviser would need to take all reasonable steps to cause the fund to undergo an audit that would meet the elements of the Proposed Rule.[24]

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20 Proposed Rule 206(4)-10(d).

21 Proposing Release at 108.

22 Proposed Rule 206(4)-10(c) and (d).

23 Proposed Rule 206(4)-10(e).

24 Proposed Rule 206(4)-10(f).

C. Fairness Opinion for Adviser-Led Secondary Transactions

Proposed Rule 211(h)(2)-2 would require an adviser to obtain a fairness opinion in connection with certain adviser-led secondary transactions. The Proposed Rule[25] defines "adviser-led secondary transactions" as transactions initiated by the investment adviser or any of its related persons that offer the private fund's 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.[26]

The opinion would need to state that "the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair." The proposal would require advisers to distribute the opinion and written summary to investors prior to the closing of the transaction.

To comply with the Proposed Rule, the fairness opinion must be issued by an "independent opinion provider," which is an entity that (i) provides fairness opinions in the ordinary course of its business and (ii) is not a related person of the adviser. The ordinary course of business requirement would largely correspond to persons with the expertise to value illiquid and esoteric assets based on relevant criteria. The Proposed Rule also would require the adviser to prepare and distribute to private fund investors a 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 fairness opinion and the summary of any material business relationship must be provided prior to the closing of the adviser-led secondary transaction.

D. Prohibitions Related to Fees, Expenses and Other Practices

Proposed Rule 211(h)(2)-1 would prohibit an investment adviser to a private fund (including exempt reporting investment advisers, state-registered investment advisers and those not registered with the SEC), directly or indirectly, from engaging in certain activities with respect to the private fund or any investor in that private fund, even if the private fund's governing documents permit these activities or if the adviser discloses the practices. The SEC believes that these prohibitions are necessary "given the lack of governance mechanisms that would help check overreaching by private fund advisers."[27] Specific prohibitions include charging a private fund or portfolio investment for:

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[25] *See* Proposed Rule 211(h)(1)-1.

[26] The SEC indicated that it generally considers a transaction to be initiated by the adviser if the adviser commences a process, or causes one or more other persons to commence a process, that is designed to offer private fund investors the option to obtain liquidity for their private fund interests. Adviser-led secondary transactions would include secondary transactions where a fund is selling one or more assets to another vehicle managed by the adviser or related persons, if investors have the option either to obtain liquidity through a sale of their interests in the fund or to roll all or a portion of their interests into the other vehicle.

[27] Proposing Release at 133.

(i) accelerated monitoring fees or other fees for services that the investment adviser does not, or does not reasonably expect to, provide to a portfolio investment;[28]

(ii) fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities;

(iii) regulatory or compliance expenses or fees of the adviser or its related persons;[29] or

(iv) fees and expenses related to a portfolio investment on a non-pro rata[30] 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;[31]

The Proposed Rule also would prohibit other financial arrangements between an adviser and the private funds it manages, including the following:

(v) Reducing the amount of any adviser clawback[32] by the amount of certain taxes;[33]

(vi) Seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence,[34] or recklessness in providing services to the private fund; and

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28 The Proposed Rule would not prohibit an adviser from receiving payments in advance for services that it reasonably expects to provide to the portfolio investment in the future.

29 The SEC highlights that certain private fund advisers use a pass-through expense model where the fund pays for these types of fees and expenses. The Proposed Rule would require advisers that pass on these types of fees and expenses to restructure their pass-through expense model.

30 The term "pro rata" is not defined under Proposed Rule 211(h)(1)-1, but the SEC has asked for comment on whether "pro rata" should be determined based on each client's ownership (or anticipated ownership) of the portfolio investment.

31 This requirement would apply to fees and expenses attributable to both consummated and unconsummated investments (*e.g.*, broken deal fees and expenses). If more than one fund would have participated in an investment that resulted in broken deal expenses, the SEC is of the view that all of the funds, including a co-investment vehicle, should bear their pro rata share of those expenses.

32 Proposed Rule 211(h)(1)-1 defines "adviser clawback" as any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements.

33 The Proposed Release identifies that an adviser would be prohibited from reducing the amount of any adviser clawback "by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders." (Proposing Release at 144).

34 Prohibiting adviser exculpation and indemnification for ordinary negligence is a significant departure from the industry standard of providing adviser exculpation and indemnification except in instances of gross negligence. Notably, investors would not be able to consent to waive these prohibitions.

(vii) Borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client.

Proposed Rule 211(h)(2)-3 would prohibit all private fund advisers (including exempt reporting investment advisers, state-registered investment advisers and investment advisers not registered with the SEC) from providing preferential terms to certain investors in a private fund, or a substantially similar pool of assets,[35] regarding redemption rights and information about portfolio holdings or exposures if the adviser reasonably expects those terms to have a material, negative effect on other investors. The Proposed Rule would prohibit advisers from providing any other preferential treatment to private fund investors unless advisers disclose such treatment to current and prospective investors in the private fund.[36] The Proposed Rule is designed to protect investors by preventing advisers from providing special redemption rights and transparency into fund holdings when these terms can have a material negative effect on other investors.

Under the Proposed Rule, an adviser would need to describe specifically the preferential treatment to convey its relevance. For example, if an adviser provides an investor with lower fee terms in exchange for a significantly higher capital commitment than paid by others, the SEC staff indicated in the Proposing Release that it does not believe that mere disclosure that some investors pay a lower fee is specific enough, rather an adviser must describe the lower fee terms, including the applicable rate (or range of rates if multiple investors pay such lower fees), to provide sufficient information under the Proposed Rule. An adviser could comply with this disclosure requirement by providing copies of side letters or providing a written summary of the preferential terms provided to other investors, so long as the summary specifically describes the preferential treatment.

E. Annual Compliance Review

The SEC proposed amendments to Rule 206(4)-7 under the Advisers Act (the "Compliance Rule"). Proposed Rule 206(4)-7(b) would require all SEC registered investment advisers, including those that do not manage private funds, to document the annual review of their compliance policies and procedures in writing.

The Compliance Rule currently requires advisers to review, no less frequently than annually, the adequacy of their compliance policies and procedures and the effectiveness of their implementation. The annual review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its

[35] Proposed Rule 211(h)(1)-1 defines "substantially similar pool of assets" as a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with investment policies, objectives, or strategies substantially similar to those of the private fund managed by the adviser or its related persons. The Proposing Release indicates that a "substantially similar pool of assets" does not include separately managed accounts, but can have any number of investors.

[36] Proposed Rule 211(h)(2)-3's requirement to provide disclosure of preferential treatment to current and prospective private fund investors could present practical difficulties for advisers from both a timing and logistical perspective.

affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies and procedures.

Proposed Rule 206(4)-7(b) does not enumerate specific elements that advisers must include in the written documentation of their annual reviews. The written documentation requirement is intended to be flexible to allow advisers to continue to use the review procedures they have developed and found most effective.

F. Books and Records

The SEC also proposed amendments to Rule 204-2 under the Advisers Act, (the "Books and Records Rule"), which would require registered advisers that manage private funds to retain copies and records relating to the Proposed Rule above. The Proposed Rule would require advisers that manage private funds to retain a copy of any quarterly statement distributed to fund investors pursuant to the Proposed Rule, as well as a record of each addressee, the date(s) the statement was sent, address(es), and delivery method(s). The Proposed Rule also would require advisers to retain all records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any quarterly statement delivered pursuant to the Proposed Rule. Finally, an adviser would be required to make and keep books and records substantiating the adviser's determination that each private fund it manages is categorized appropriately as a liquid fund or an illiquid fund.

G. Comment and Transition Periods

Comments on the Proposed Rules are due 30 days after the publication of the Proposing Release in the Federal Register or 60 days after the publication of the Proposing Release on the SEC's website (*i.e.*, April 11, 2022), whichever is longer. If adopted, the Proposed Rules would have a one-year transition period for advisers to come into compliance.

H. Conclusion

The new requirements under the Proposed Rules emphasize the SEC's continued focus on private funds and private fund advisers. The Proposed Rules would impose significant new requirements not within the scope of current regulations applicable to private fund advisers. If the Proposed Rules are adopted, investment advisers to private funds will need to review and update investor reporting and disclosure practices, compliance policies and procedures, and related recordkeeping practices. If adopted as is, private fund advisers might also need to alter fund governing documents and side letter arrangements with investors. We expect that the private fund industry will seek to engage with the SEC during the comment period as private funds advisers anticipate applying the requirements of the Proposed Rules to their private funds.

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