February 15, 2022

SEC's Proposed Private Fund Reforms

The SEC recently released proposed private fund reforms. These rules and amendments are only proposed at this point and are subject to public review and comment. The comment period will be open for 30 days after publication in the Federal Register or April 11, 2022 (60 days after issuance), whichever is later. We expect at least a few months, if not longer, between the end of the comment period and the publication of any final rules. The Commission proposed a one-year transition period following the rules' effective dates to provide time for advisers to come into compliance with the new and amended rules if they are adopted.

Quarterly Statement Rule (Proposed Rule 211(h)(1)-2)

- The proposed rule would require a registered investment adviser to prepare a quarterly statement that includes certain information regarding fees, expenses, and performance (further described below) for any private fund that it advises and distribute the quarterly statement to the 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 (e.g., in the case of a sub-advised fund).
    - Under the definition of "distribute," the statement would need to be sent to all investors (if the investor is a pooled investment vehicle controlled by the adviser or its related persons (defined consistently with Form ADV), investors in those pools must receive the statements).
    - The Commission has requested comment on whether to revise the definition of "distribute" (which is currently silent on this matter) to expressly include distribution by granting investors access to a virtual data room containing the quarterly statement.
- The proposed rule would require advisers to consolidate reporting for substantially similar pools of assets to the extent doing so would provide more meaningful information to the fund's investors and would not be misleading (e.g., in the case of parallel and master-feeder structures). In the case of a newly formed fund's initial quarterly statement, the statement would include the first two full calendar quarters of operating results.
- The proposed rules would exclude real estate funds relying on 3(c)(5) from this requirement (and the SEC has asked for comment on that point).
- The SEC has also asked commenters whether certain common private fund fee and expense arrangements should be prohibited (i.e., the "2 and 20 model," fees at the fund level above certain maximum fees to be prescribed by rule, compensation from portfolio investments to the extent management fees are also received, performance-based compensation, management fees being charged as a percentage of committed capital, or certain other expense practices or arrangements, such as expense caps provided to certain, but not all, investors).

General Format and Content Requirements; Disclosure

- The proposed rule includes general format and content requirements meant to improve legibility and to make comparing funds easier (but it purposefully does not go so far as to mandate a specific reporting structure).
    - The proposed rule would require fees and expenses to be listed as separate line items by total dollar amount per specific category (e.g., insurance premiums, administrator expenses, or auditor fees), representing a change from aggregated expenses that we commonly see in standard financial statements.

- The proposed rule would also require an adviser to present the dollar amount of compensation and fund expenses before and after any reduction due to offset, rebate, or waiver for the reporting period.

- An adviser would remain free to include other performance metrics in the 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.

- Each statement would need to include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated.

- The quarterly statement would also need to include cross references to the relevant sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.

Fund-Level Disclosure on Fees and Expenses

- Under the proposed rule, advisers would be required to provide the following information in table format: (1) detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the fund during the reporting period; (2) detailed accounting of all fees and expenses paid by the fund during the reporting period other than those listed in (1); and (3) 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.

    - Expenses would include, but not be limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses. They would also include start-up and organizational fees of the fund if they were paid during the reporting period.

Portfolio Investment-Level Disclosure on Compensation and Ownership

- Under the proposed rule, advisers would be required to provide the following information in table format: (1) a detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period; and (2) the fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period (or zero percent, with a description of the fund's investment in such covered portfolio investment, in cases where the fund does not have an ownership interest – such as where the fund only holds a debt investment).

    - Portfolio investment compensation includes, but is not limited to, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees, or similar fees or payments.

Performance Disclosure

- In addition, the proposed rule would require an adviser to include standardized fund performance information in each quarterly statement provided to fund investors.

- The proposed performance disclosure requirements of the quarterly statement rule would require an adviser first to determine whether its private fund client is an "illiquid" or "liquid" fund no later than the time the adviser sends the initial quarterly statement, because determining which requirements are applicable would be dependent on that characterization.

- An illiquid fund would be defined as one that: (1) has a limited life; (2) does not continuously raise capital; (3) is not required to redeem interests upon an investor's request; (4) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (5) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (6) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments (e.g., private equity, real estate, and venture capital funds).

- A liquid fund would include any other fund.

- However, comment has been requested on whether the rule should eliminate these definitions and give advisers discretion to provide the proposed performance metrics that they believe most accurately portray the fund's returns.

- For illiquid funds, the proposed rule would require an adviser to show performance based on the IRR and a MOIC (both of which would have specific definitions to limit any deviations in calculating the standard performance prescribed by the proposed rule).

  - 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 (for which advisers would have to exclude fees and expenses).

  - An adviser would need to disclose the assumed fee rates including whether the adviser is using fee rates set forth in the fund documents, whether it is using a blended rate or weighted average that would factor in any discounts, or whether it is using a different method for calculating net performance.

- An adviser to a liquid fund would need to show performance based on net total return (which is not currently defined in the proposed rule) (1) on an annual basis for each calendar year since the fund's inception, (2) as average annual net total returns over the one-, five-, and ten- calendar year periods if applicable, and (3) as cumulative net total return for the current calendar year as of the end of the most recent calendar quarter, as well as on a quarterly basis for the current year.

  - If the adviser made any assumptions in performing that calculation, such as whether dividends were reinvested, the adviser would need to disclose those assumptions in the quarterly statement.

- The proposed rule would require an adviser to display the different categories of required performance information with equal prominence.

- An adviser would not be able to provide the information only in a separate document, website hyperlink or QR code, or other separate disclosure.

Private Funds Adviser Audit Rule (Proposed Rule 206(4)-10)

- A second proposed rule would require advisers to obtain an annual audit of the financial statements of the private funds they manage, as well as on liquidation, unless the fund otherwise undergoes such an audit.

- If enacted as proposed, the audit would need to: (1) be performed by an independent public accountant that meets the standards of independence in rule 2-01(b) and (c) of Regulation S-X that is registered with and subject to regular inspection of the PCAOB; (2) meet the definition of audit in rule 1-02(d) of Regulation S-X, the professional engagement period of which shall begin and end as indicated in Regulation S-X rule 2-01(f)(5); and

(3) be prepared in accordance with GAAP, or in the case of a foreign private fund, contain information substantially similar.

- "Promptly" after completion, the audited financial statements would need to be distributed.
    - While the deadline is not concrete, the Commissioners do reference 120 days as a generally reasonable timeline absent extenuating circumstances.
- 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 provides services to the fund), such adviser would only need to take all reasonable steps to cause the fund to undergo an audit that would meet these elements.
- Moreover, the proposing release notes that the Commission considered additional modifications to the audit requirement for a private fund during liquidation but was concerned that allowing for less frequent auditing (e.g., every 18 months or two years) during an entity's liquidation might expose investors to abuse that could then go unnoticed for prolonged periods.
- Additionally, under the proposed rule, there would need to be a written agreement between the adviser or the private fund and the auditor pursuant to which the auditor would be required to notify the Division of Examinations promptly (i) 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.

Adviser-Led Secondaries Rule (Proposed Rule 211(h)(2)-2)

- The proposed adviser-led secondaries rule would prohibit an adviser from completing an adviser-led secondary transaction with respect to any private fund, unless the adviser distributes to investors in the private fund, prior to the closing of the transaction, a fairness opinion from an independent opinion provider and 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 (i.e., one that (i) provides fairness opinions in the ordinary course of its business and (ii) is not a related person of the adviser).
- The proposed rule would require an 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.
    - For purposes of the proposed rule, audit, consulting, capital raising, investment banking, and other similar services would typically meet the business-relationship standard.
- Defined Terms Specific to the Proposed Rule
    - Fairness opinion would mean a written opinion stating 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 rule would define adviser-led secondaries 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.

- Examples of such transactions may include single asset transactions (such as the fund selling a single asset to a new vehicle managed by the adviser), strip sale transactions (such as the fund selling a portion of multiple assets to a new vehicle managed by the adviser), and full fund restructurings (such as the fund selling all of its assets to a new vehicle managed by the adviser).

Prohibited Activities Rule (Proposed Rule 211(h)(2)-1)

- The proposal would prohibit all private fund advisers, including those that are not registered, from engaging in certain activities and practices, regardless of whether a fund's governing documents permit such activities or whether they are disclosed or consented to, or whether they are performed indirectly.

- These practices, which are further described below, include: (1) accelerated payments, characterized as fees for "unperformed services"; (2) certain regulatory and compliance fees and expenses; (3) reduction of adviser clawbacks for taxes; (4) limitation or elimination of liability for adviser misconduct; and (5) certain non-*pro rata* fee and expense allocations.

- The Commission has asked for comment on whether the rule should apply to all advisers as proposed (as opposed to only registered advisers), and whether the prohibitions should only take effect if the adviser does not satisfy certain governance and other conditions (e.g., disclosure to investors in all relevant funds/vehicles, or approval by a limited partner advisory committee (or other similar body) or directors).

Accelerated Payments

- The proposed rule would prohibit an adviser from charging a portfolio investment "accelerated payments," including those fees assessed for monitoring, servicing, consulting, or other services in respect of any services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment.

- However, 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.

- A fund with a 100% management fee offset would not comply if the adviser retained excess fees and no further management fee offset could be applied (e.g., at the end of fund life), and the private fund investors were not offered a rebate or other economic benefit equal to their *pro rata* share of any such excess fees.

Certain Regulatory Fees and Expenses

- The prohibited activities rule would prevent an adviser from charging a fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, as well as regulatory and compliance fees and expenses of the adviser or its related persons.

- The proposed rule would allow charging funds for regulatory, compliance or other similar fees and expenses directly related to the activities of the fund (e.g., costs associated with a regulatory filing of a fund, such as Form D).

    - Where proper allocation is unclear, an adviser would be expected to allocate the fees and expenses in a manner that it believes in good faith is fair and equitable, and consistent with its fiduciary duty.

Reduction of Adviser Clawbacks for Taxes

- The proposed rule would prohibit an adviser 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.

- Adviser clawback means 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.

- The proposed rule release has asked whether the SEC should go even further, and prohibit deal-by-deal (i.e., "American") waterfalls altogether.

Limiting or Eliminating Liability for Adviser Misconduct

- The proposed rule would prohibit advisers, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of liability by their funds or investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the funds.

- Included in the specific types of contractual provisions that would be invalid is indemnification for breaching a fiduciary duty, regardless of whether state or other law would permit an adviser to waive its fiduciary duty.

Certain Non-Pro Rata Fee and Expense Allocations

- The proposed rule would prohibit an adviser from directly or indirectly charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-*pro rata* basis when multiple clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment.

- The proposed rule does not include an exception for omitting co-investment vehicles or other co-investors from fee and expense allocation related to dead deals.

    - The Commission has asked whether the proposed rule would make it difficult for funds to consummate larger investments where co-investment capital is needed or cause funds to syndicate more deals post-closing once the adviser is confident that the deal will not fall through.

    - It has also asked whether single-deal co-investment vehicles should be treated differently than multi-deal co-investment vehicles.

Borrowing or Receiving an Extension of Credit from a Client

- The proposed rule would prohibit an adviser from directly or indirectly borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a client, such as using fund assets as collateral in order to obtain a loan from a party other than the fund (i.e., borrowing against fund assets), accepting a loan offered by a private fund client, and taking advantage of a continuous line of credit extended by a private fund client.

- The proposed rule would not prevent the adviser from borrowing from a third party on the fund's behalf or from lending to the fund.

Preferential Treatment Rule (Proposed Rule 211(h)(2)-3)

- *Blanket Prohibition:* The proposal would prohibit all private fund advisers, regardless of whether they are registered with the Commission, from (i) providing preferential terms to certain investors in private funds or in substantially similar pools of assets (such as parallel funds) regarding redemption, or (ii) providing certain information about portfolio holdings or exposures only to certain private fund investors if, in each case, the adviser reasonably expects such preferential terms or information to have a material, negative effect on other investors in the private fund.

- *Allowed with Disclosure:* The rule would allow for other types of preferential treatment to be disclosed in advanced written notice to prospective investors and annual written notice to current investors, on the theory that other types of preferential treatment do not necessarily disadvantage other fund investors.

    - An adviser would need to describe specifically the preferential treatment to convey its relevance.

    - An adviser could comply with the proposed disclosure requirements by providing copies of side letters (with identifying information regarding the other investors redacted).

- The timing of the proposed rule's delivery requirements would differ depending on whether the recipient is a prospective or existing investor in the private fund.

    - For a prospective investor the notice would need to be provided, in writing, prior to the investor's investment.

    - For an existing investor, the adviser would have to "distribute" the notice annually if any preferential treatment is provided to an investor since the last notice.

- The proposed rule release asks (among a number of questions) whether the SEC should simply prohibit all preferential terms with respect to redemption, or (which may amount to the same thing) all preferential terms which *could* have a material, negative effect on other investors.

Books and Records and Written Annual Review of Compliance Policies and Procedures

In addition, the proposal has included updates to the books and records rule, new definitions, and a requirement that all registered advisers, including those that do not advise private funds, document the annual review of their compliance policies and procedures in writing. The Commission has noted that the proposed 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. In the context of the proposed written documentation of annual reviews of compliance programs, the Commission stated its concerns related to 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. It explained that attempts to shield from, or unnecessarily delay, production of any non-privileged record is inconsistent with prompt production obligations and undermines the Commission staff's ability to conduct examinations.