SEC Proposes Extensive New Rules Applicable to Private Fund Advisers

February 18, 2022

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Background

On February 9, 2022, the Securities and Exchange Commission (the "SEC") proposed extensive new rules applicable to private fund advisers (the "Proposed Rules") that, if adopted, would fundamentally change how private fund advisers conduct their business in a way not seen in over a decade, since Congress amended the Investment Advisers Act of 1940 (the "Advisers Act") to require most private fund advisers to register with the SEC.[1] The Proposed Rules mandate specific disclosures and prohibit specific commercial terms; both of these components will significantly impact the operation and economics of private funds.

In proposing the new rules, the SEC focused on a perceived lack of investor transparency and the SEC's concern that investors may be unable to compare economic terms across funds. In addition, the SEC has essentially identified certain conflicts of interest as unacceptable by singling out and prohibiting certain fund terms.

The SEC and its staff had previewed their concerns regarding many of the issues covered in the Proposed Rules. Chair Gensler's remarks at the Institutional Limited Partners Association (ILPA) Summit in November 2021 telegraphed a number of the

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Proposed Rule, IA-5955 (February 9, 2022) (the "Proposal").

proposals – focusing heavily on information transparency, performance metrics, side letters, and waivers or reductions of an adviser's fiduciary obligation.[2] Indeed, many provisions of the Proposed Rules closely mirror positions that ILPA has championed over the years.[3] Even before Chair Gensler was sworn in as Chair of the SEC, the staff of the Division of Examinations ("EXAMS") had identified a handful of the issues addressed in the Proposed Rules in its 2020 Risk Alert relating to private funds, including preferential liquidity rights, fund restructurings and stapled secondary transactions, allocation of fees and expenses among clients, and the disclosure of portfolio-level fees (with a specific reference to accelerated monitoring fees).[4] And, just the week before the Proposal was released, EXAMS issued another risk alert relevant to private funds,[5] referenced in the Proposal for its guidance on hedge clauses.[6]

As we detail below, the prohibitions in the Rule Proposal, if adopted, will dramatically affect the private fund industry. And, if adopted as proposed, the prohibitions, which arguably are the most problematic elements of the Proposed Rules, will apply to all advisers to private funds, not only those registered with the SEC under the Advisers Act.

Set out below is a summary of our key takeaways from the Proposal and a summary of the Proposed Rules.

Key Takeaways

- The Proposed Rules represent a dramatic shift for the SEC, which has administered and enforced a largely disclosure-based regime applicable to private fund advisers and a significant change for Advisers Act rulemaking, which historically has favored principles-based regulation over prescriptive requirements. The SEC and its staff seem to be veering away from the long-agreed position, reflected as recently as 2019,[7] that a disclosure-based regime is appropriate in the private funds space, in which it

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[2] Prepared Remarks At the Institutional Limited Partners Association Summit, SEC Chair Gary Gensler, November 10, 2021 (*available at* https://www.sec.gov/news/speech/gensler-ilpa-20211110)

[3] See e.g., ILPA Principles 3.0, *Institutional Limited Partners Association* (2019) (*available at* https://ilpa.org/wp-content/flash/ILPA%20Principles%203.0/?page=1).

[4] Office of Compliance Inspections and Examinations ("OCIE") National Examination Program Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020) *available at* https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf. OCIE was renamed the Division of Examinations ("EXAMS") in December 2020.

[5] EXAMS National Examination Program Risk Alert: Observations from Examinations of Private Fund Advisers (Jan 27. 2022) *available at* https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf.

[6] See e.g. Proposal at note 16. This risk alert suggests that EXAMS is further increasing its focus on hedge clauses.

[7] See, e.g., Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)] ("2019 Fiduciary Duty Interpretation")

is customary for sophisticated parties to heavily negotiate market terms in private transactions.

- The Proposed Rules also represent an attack by the SEC on the treatment of private funds under the Investment Company Act of 1940 (the "1940 Act"), which exempts private funds (and their investment advisers and other affiliates of a private fund) from the very type of disclosure and conduct-based regulation that is the subject of the Proposed Rules. The Proposed Rules thus appear to be inconsistent with the 1940 Act's treatment of private funds as exempt from such type of regulation.

- As was pointed out by Commissioner Peirce in her dissenting statement, the Proposed Rules effectively blur the line between retail investors, whom Congress and the SEC for decades have recognized as requiring all of the protections of the federal securities laws, and sophisticated investors, who as a class have been recognized by Congress and the SEC as not requiring the same protections. It necessarily follows, as noted by Commissioner Peirce, that retail investors, armed with the type of information and substantive protections that the Proposed Rules would provide, will be in a position to invest directly in private funds, a positon the current SEC has been unwilling to recognize.

- Notably, the Proposed Rules prohibit tax related carveouts from GP clawback provisions, and would prevent advisers from seeking certain indemnities from funds, thus imposing a higher standard of care. These elements of the Proposed Rules in particular have the potential to cause a shift in preference away from traditional private funds, in favor of pledge funds and single-asset structures.

- Due to the absence of any grandfathering provisions in the Proposed Rules, their requirements will seemingly apply to all private funds on the date the Proposed Rules come into effect. Given the far-reaching impact of the Proposed Rules, a large number of fund advisers may find that their existing negotiated agreements may not be compliant at that time. Among other things, this may cause advisers to terminate existing funds early and raise new funds with compliant terms, increased costs, and re-negotiated side letters. The resulting disruption in the markets could also significantly impact the dry powder available and the management of existing investments and co-investments, and could severely diminish investor returns and affect the operations of portfolio companies.

- In our view, private fund advisers are likely to consider increasing management fees to cover the costs of the Proposed Rules as they apply to private funds, and we expect that overall fund expenses could increase due to increased insurance, compliance, and reporting costs (e.g. audit expenses and quarterly reporting expenses).

- Due to the prohibition on certain preferential side letter terms, anchor and strategic investors may actually see their leverage diminished. Participating in an initial closing or backing a new adviser's first fund may become less appealing for investors.

- Similar to the uptick in examination and enforcement activity in the years following the passage of the Dodd-Frank Act, private fund advisers should expect heightened examination and enforcement activity from the SEC's Division of Examinations and the Division of Enforcement, and should be prepared to demonstrate compliance with the Proposed Rules upon their effectiveness. The adjustment to the standard of care, as further discussed below, will likewise increase the chance that examiners will be able to more easily assert regulatory deficiencies.

The SEC is accepting comments until the later of April 11, 2022 or 30 days from the date the proposal is published in the Federal Register.

Summary of the Proposed Rules

The Proposed Rules would prohibit various economic arrangements that have come to be market standard across a large spectrum of the private funds and would impose new reporting and disclosure requirements on private fund advisers. While some rules will apply only to registered investment advisers, others will apply to all advisers to private funds (including exempt reporting advisers such as venture capital fund advisers).

PROHIBITED ACTIVITIES

These prohibitions apply to *all advisers to private funds*, including those exempt from registration.

- **Prohibition on certain indemnities**: The Proposed Rules prohibit advisers from seeking indemnification or otherwise limiting the adviser's liability for its breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.

    - *Note*: If adopted, this provision could hinder a fund sponsor's (the general partner, or "GP") ability to engage in the day-to-day decision making that is necessary for funds to perform and for investors to realize returns. Fund investors (limited partners, or "LPs") invest in funds because they rely on an adviser's expertise and discretion. Both GPs and LPs expect that LPs will generally be passive investors. While it is true that private fund investments are inherently risky, investments in private funds are typically limited to sophisticated investors that can fully assess the potential risks of their

investment and can afford to bear such risk. The Proposed Rules heighten the potential for adviser liability for business judgments made in good faith that would have otherwise been protected (similar to the concept of the "business judgment rule," as applicable to boards of directors). This proposal is likely to drastically increase insurance expenses and management fees for investors across the private fund market.

- **Restrictions on GP clawbacks**: An adviser may not reduce the amount of a GP clawback by taxes (hypothetical or otherwise). Most private equity fund distributions are subject to a GP clawback to correct excess distributions of carried interest to the GP. GPs would be prohibited from reducing distributions clawed back by funds by taxes paid or deemed paid by the GP (or its principals).
    - *Note*: This proposal could change the way that carried interest is charged by pushing GPs to delay making distributions to reduce the risk of excess clawbacks. A delayed distribution of carried interest could lead to a restructuring of fund economics to avoid a clawback altogether. This would likely yield higher management fee compensation during the life of the fund, and higher ultimate carried interests. It could also lead to the reduction or elimination of fee-free and carry-free co-investment vehicles.
- **Prohibition on certain fees and expenses**: An adviser may not charge for certain fees and expenses, including those associated with: services not provided, the Adviser's regulatory or compliance matters, or examinations and investigations. The prohibitions include:
    - Charging portfolio companies for services not provided or not reasonably expected to be provided (e.g., accelerated monitoring fees).
    - Charging the fund for fees or expenses related to an examination or investigation of the adviser or any regulatory or compliance fees or expenses of the adviser or its related persons. It is unclear to what extent investigations or examinations relating to a fund's investment activity would be deemed related to the fund, and therefore chargeable to the fund.
- **Prohibition on non-pro rata cost allocations**: An adviser may not charge fees or expenses related to portfolio investments on a non-pro rata basis among clients.
    - *Note*: This will require the allocation of broken-deal expenses to clients on a pro rata basis and, specifically, will require pro rata allocation of expenses among any co-investment vehicles and funds participating in an investment. Currently, fund advisers often exempt co-investment vehicles from certain expenses

(particularly broken-deal expenses) in return for bringing additional capital to an investment. Fund disclosure puts fund investors on notice that the fund may pay all or a higher pro rata share of fees and expenses associated with an investment in light of the importance of co-investment vehicles to certain investments. A shift in this cost structure may limit the available of co-invest capital for GPs, as it is likely to reduce certainty regarding investments that require additional capital from a co-investment vehicle.

- **Prohibition on borrowings from private funds:** The Proposed Rules also prohibit advisers from borrowing or receiving an extension of credit from a private fund client.
    - *Note*: There is an opportunity through the comment process to provide examples of borrowing or extensions of credit that should not be subject to the prohibition, provided that governance and protections exist (such as advance disclosure and investor consent).

PROHIBITIONS ON PREFERENTIAL TREATMENT (SIDE LETTER TERMS)

These prohibitions apply to all advisers to private funds, including those exempt from registration.

- **Certain Preferential Terms Prohibited:** Prohibits all private fund advisers from providing preferential terms to certain investors regarding redemptions from the fund or information about portfolio holdings or exposures.
    - *Note*: If adopted, this will prohibit preferred information rights. The prohibition on preferential redemption rights is unlikely to impact private equity fund advisers as significantly as it will affect hedge fund advisers.
- **Side Letter Disclosure Requirement:** Prohibits all private fund advisers from providing other preferential treatment unless disclosed to current and prospective investors. Specific terms (e.g., the exact reduced fee rate agreed with another investor) must be disclosed, but investor information may be redacted.
    - *Note*: Differential reporting is often driven by investor-specific requirements and state or local laws. Institutional LPs in particular are themselves often subject to specific reporting requirements, which necessitate the receipt of custom reports from the private funds they are invested in.

REQUIREMENTS APPLICABLE TO ADVISER-LED SECONDARIES

These requirements apply *only to registered investment advisers* that advise private funds.

- **Fairness Opinion:** Requires advisers to obtain and distribute to investors a fairness opinion from an independent opinion provider before closing on an investment in an adviser-led secondary transaction.

  - *Note*: A fairness opinion will increase investor expenses associated with the transaction. As demonstrated in the Proposed Rules and the Form PF proposal from earlier this year,[8] the SEC appears to believe that adviser-led secondary transactions present significant risk to investors, whereas in practice advisers often initiate these transactions solely for the benefit of investors. Indeed, there are very few published SEC enforcement actions dealing with adviser-led secondary transactions.

- **Material Business Relationships:** Requires advisers to prepare and distribute a written summary to investors of material business relationships between the adviser and the opinion provider in the last two years before closing.

  - *Note*: What constitutes a "material business relationship" is likely to be a point of contention given the lack of clarity in the Proposal.

QUARTERLY STATEMENTS

These requirements *apply only to registered investment advisers* that advise private funds.

- **Quarterly Statement Requirement:** Requires private fund advisers registered with the SEC to provide fund investors with quarterly statements detailing information about the private fund's performance, fees, and expenses. Information must be distributed within 45 days after each quarter end. Quarterly statements must include the fund table, the portfolio investment table, and performance information, as follows:

- **The Fund Table – Information at the Fund Level:**

  - All information must be presented before and after offsets, rebates, and waivers.

  - A detailed accounting of all compensation and fees allocated or paid to the investment adviser by the fund, with separate line items for management, advisory, sub-advisory, performance-based compensation, and other relevant categories.

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[8] Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers; Proposed Rule; IA-5950 (January 26, 2022).

- A detailed accounting of all fees and expenses paid by the fund to any party with separate line items for organizational, accounting, legal, administration, audit, tax, due diligence, travel fees and expenses, and other relevant categories.
- The amount of any offsets or rebates carried forward by the adviser during the reporting period to subsequent periods that will reduce future payments or allocations to the adviser.

- **The Portfolio Investment Table – Information at the Portfolio Company Level:**
  - Disclose information about portfolio investments that allocated/paid compensation to the adviser (e.g., origination fees, management fees, consulting fees, monitoring fees, transaction fees, director fees, advisory fees and any compensation).
  - A detailed accounting of all compensation allocated or paid to the adviser with a separate line item for each category, presented both before and after the application of offsets, rebates, or waivers.
  - The fund's ownership percentage of the relevant portfolio investment as of the end of the reporting period.
- **Performance Reporting:**
  - Liquid funds: the quarterly statement must provide annual net total returns since inception, average annual net total returns over prescribed time periods, and quarterly net total returns for the current calendar year.
  - Illiquid funds: the quarterly statement must provide the gross and net internal rate of return and gross and net multiple of invested capital for the illiquid fund to capture performance from the fund's inception through the end of the current calendar quarter.

ANNUAL AUDIT

These requirements *apply only* to registered investment advisers that advise private funds.

- **Annual Audit from an Independent Public Accountant:** Requires private fund advisers registered with the SEC to distribute audited financial statements annually and upon liquidation. Audits must generally be conducted in accordance with U.S. GAAS, and financial statements must be presented in accordance with U.S. GAAP,

although non-U.S. funds (or funds with non-U.S. advisers/GPs) may have financial statements prepared in accordance with other accounting standards so long as they are sufficiently similar to U.S. GAAP and include reconciliation to U.S. GAAP. Similar to the requirements of the Custody Rule's audit exemption, the auditor must be registered with the PCAOB and subject to inspection. The increased demand for auditors with appropriate credentials may increase demand and thereby increase fund expenses.

- **Written Agreement:** Advisers must enter into a written agreement with the independent public accountant conducting the audit, pursuant to which, the auditor shall notify the SEC if it issues an audit report that contains a modified opinion or upon termination/dismissal/resignation/removal from consideration for being reappointed.
  - *Note*: The impact of this rule will likely vary between private funds, as many already undergo annual audits required under other provisions of the Advisers Act (the so-called "Custody Rule"). However, it is unclear whether certain special purpose vehicles and co-invest vehicles that do not obtain custody audits could still be subject to this requirement.

COMPLIANCE

- **Annual Compliance Review Documented in Writing:** The Proposed Rules would require registered investment advisers' annual compliance reviews to be documented in writing. The Commission recognized in the Proposal that advisers often claim attorney-client privilege over records documenting annual compliance reviews conducted in accordance with Rule 206(4)-7 of the Advisers Act. The Commission expressed the view that documentation of the annual review required under the Proposal would not be subject to attorney-client privilege, the work-product doctrine, or other similar protections and thus must be produced to EXAMS staff without unnecessary delay.[9]
- **Cybersecurity Rule Proposal:** The SEC separately proposed rules applicable to cybersecurity compliance for registered investment advisers, which would include a requirement to confidentially report certain cybersecurity events to the SEC. For more information, see our Four Takeaways from the SEC's Proposed Cybersecurity Rules.

[9] See Proposal at note 214.

Conclusion

The SEC is accepting comments until the later of April 11, 2022 or 30 days from the date that the proposal is published in the Federal Register. Many of the comment requests in the Proposing Release suggest that, while there may be some flexibility in the final version of the rules, the SEC is open to considering even more stringent requirements and prohibitions for the final rules.

We expect that the Proposed Rules will garner several comment responses and significant industry engagement with the SEC. We encourage members in the industry to consider how the Proposed Rules may affect their commercial and compliance operations, given the potential of the Proposal to radically change longstanding commercially accepted terms.

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