Hogan Lovells

Private Capital Alert
16 February 2022

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SEC proposes reforms to enhance private fund transparency

The U.S. Securities and Exchange Commission (SEC) proposed new rules promulgated under the U.S. Advisers Act of 1940 (the Advisers Act) on Wednesday, 9 February 2022. Pointing to over US$18 trillion in assets under private fund management and the growth of private funds in recent years, the SEC is introducing five related reforms, which it states are designed to protect private fund investors and to increase transparency, competition, and efficiency in the private fund market.

Broadly speaking, the proposed rules would impose five new requirements on private fund advisers:

— a **quarterly reporting requirement** that includes information about private fund fees and expenses and portfolio performance;

— an **annual audit requirement** for private funds;

— for adviser-led secondary transactions, a **fairness opinion requirement** and enhanced disclosures;

— **prohibition of certain activities** involving conflicts of interest or charging certain fees and expenses; and

— full disclosure to all investors of **preferential treatment** of other investors (such as through side letters).

Some of the new rules, especially as to the prohibition of certain activities, will impose new limits on the practices of private fund managers for which the SEC believes neither disclosure nor consent is sufficient to ameliorate. Other new rules seek to harmonize, clarify, or standardize disclosures that many private fund sponsors are already providing to investors, and that many investors already expect as “market” standards for private fund disclosure.

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<tr><td>Registered investment advisers</td><td>Detailed disclosure about fees and expenses, portfolio company imbursement, plus net/gross performance data, detailed for liquid, and illiquid funds</td><td>Similar to annual audit for custody rule, no proscribed time limit (but surprise audits don’t meet requirement)</td><td>Fairness opinion required, plus additional conflicts disclosure</td><td rowspan="2">Cannot charge accelerated monitoring fees, non-pro rata fees and expenses, IA expenses; other restrictions apply to all advisers</td><td rowspan="2">No preferential treatment in respect to redemptions or transparency; other preferential treatment is prohibited unless disclosed to investors (including potential investors)</td><td>Already required</td></tr>
<tr><td>Exempt reporting advisers (and other exempt advisers)</td><td>N/A, but SEC specifically requests comments about scope</td><td>N/A, but SEC specifically requests comments about scope</td><td>N/A</td><td>Rules would introduce written annual review</td></tr>
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The proposed rules would be subject to a one-year transition period, and any final rules adopted by the SEC may differ significantly from this proposal following the comment period.

In its proposal, the SEC provides that the new prohibited activities and preferential treatment disclosure requirements will apply to all advisers, including those that are exempt reporting advisers (ERAs) relying on the private fund adviser exemption or the venture capital fund adviser exemption, and also including those that are exempt from registration because they are foreign private advisers or advisers solely to small business investment companies (SBICs). In contrast, the SEC proposes that the quarterly reporting, annual audit, and secondary fairness opinion requirements would apply only to registered investment advisers (RIAs) and private funds. The SEC, however, is requesting comments on the scope of all of the proposed requirements, so it remains uncertain which, if any, of the five reforms would ultimately apply to exempt fund advisers.[1]

The SEC also proposes certain amendments to Rule 204-2 (the "books and records rule") to require registered private fund advisers to maintain additional records in respect of the new rules.

Also, in addition to the five headline reforms listed above, the SEC proposes to require all private fund advisers, including ERAs, to document the annual review of their compliance policies in writing, effectively extending the current requirement from RIAs to all private fund advisers.[2]

On the same day, the SEC proposed a new cybersecurity rule that, among other things, would require all RIAs to adopt written cybersecurity policies and procedures and report certain cybersecurity incidents to the SEC pursuant to the new Form ADV-C.

These proposed rules follow a third proposal on 26 January amending rules relating to Form PF that, among other things, would lower the threshold for filing Section 4 of Form PF for "larger private equity advisers" from US$2 billion to US$1.5 billion in regulatory assets under management, and would require additional reporting from large hedge fund advisers and large private equity advisers, in some cases within one business day.[3]

The proposed private funds rule is available in full here. The public comment period will remain open for the longer of 60 days following publication of the proposing release on the SEC's website or 30 days following publication of the proposing release in the Federal Register.

Prohibited activities

The new rules prohibit all private fund advisers from engaging in certain activities and practices that are contrary to the public interest and the protection of investors.[4] Given that the SEC proposes to prohibit all advisers (not just RIAs) from engaging in these activities, notwithstanding prior disclosure or investor consent, this prohibition may be the most consequential of the five reforms.

The prohibited activities include the following:

- charging certain fees and expenses to a private fund or its portfolio investments, including:
  - fees for unperformed services (*e.g.*, accelerated monitoring fees),
  - fees associated with an examination or investigation of the adviser,
  - regulatory of compliance expenses or fees of the adviser or its related persons, or
  - charging fees or expenses related to a portfolio investment on a non-*pro rata* basis;
- reducing the amount of any adviser clawback by the amount of certain taxes;

1 While the anti-fraud provisions of Section 206 of the Advisers Act apply to all advisers, and while Section 206 remains the heart of SEC rulemaking, the SEC is proposing these new rules chiefly under Section 211(h), part of the Dodd-Frank reform amendments to the Advisers Act that empowers the SEC both (i) to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest" and (ii) to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the [SEC] deems contrary to the public interest and the protection of investors."

2 Proposed rule 206(4)-7(b).

3 Proposed rule 204(b)-1. The SEC adopted the original Rule 204(b)-1 in 2011 to require registered private fund advisers to complete Form PF within 120 days of the end of the fiscal year, including Section 4 for certain "large private equity advisers."

4 Proposed rule 211(h)(2)-1.

- seeking reimbursement, indemnification, exculpation, or limitation of its liability for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund; and
- borrowing or receiving an extension of credit from a private fund client.

Often, multiple fund vehicles may share in the same portfolio investment (i.e. multiple funds, co-investment entities, funds of one, or other multi-platform arrangements.) The SEC is proposing to prohibit any non-*pro rata* allocation of fees and expenses among such private funds.

The SEC believes that any non-*pro rata* allocation under these circumstances is contrary to the protection of investors because it would result in the adviser placing its own interest ahead of another's, including in circumstances where the adviser indirectly benefits by placing the interests of one or more clients or investors ahead of another's (including, for example, in a way that could maximize the adviser's compensation).

In particular, private fund advisers should note that the SEC proposes that even broken-deal expenses for an unconsummated portfolio investment be shared among private funds and potential co-investors, rather than be borne solely by the main fund and its investors.

Quarterly reporting requirement

The new rules require registered private fund advisers to provide investors with quarterly statements detailing information about private fund performance, fees, and expenses, potentially harmonizing the quarterly reports that many private fund advisers already provide to their investors.[5]

The quarterly report would include a detailed accounting of all fees and expenses paid by the private fund during the reporting period, disclose information regarding compensation or other amounts paid by the private fund's portfolio investments to the adviser or any of its related persons, and disclose information regarding the private fund's performance.

The fees and expense report would show, as separate categories, both (i) adviser compensation (*e.g.,* management fees, fee income, and/or performance-based compensation), with separate line items for each category of allocation or payment, and (ii) fund expenses (*e.g.,* organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses), again with separate line items for each category. The reporting would also include the amount of any offsets or rebates carried forward during the reporting period to subsequent quarters to reduce future payments or allocations to the adviser (or related persons).

In addition, the portfolio investment-level disclosure would include: (i) a detailed accounting of all portfolio investment compensation allocated or paid by each portfolio investment during the reporting period and (ii) the private fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period. Such portfolio investment compensation would include, among other things, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees, or similar fees or payments by the covered portfolio investment, again with separate line items for each category.

The proposed rule introduces a new definition of "illiquid fund" as generally closed-end funds that do not offer periodic redemption options, other than in exceptional circumstances, and that do not invest in publicly traded securities (except for a *de minimis* amount), intended to capture most private equity, real estate, and venture capital funds. Funds that do not meet these criteria are defined as "liquid funds," and is designed to capture most hedge funds.

For liquid funds, the quarterly statement would provide annual net total returns since inception, average annual net total returns over the one-, five-, and ten- calendar year periods, and quarterly net total returns for the current calendar year.

For illiquid funds, the statement would 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. The requirement for both gross and net performance matches the emphasis on dual gross and net performance in the marketing rule adopted by the SEC in December 2020, which takes effect in November 2022.[6]

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5 Proposed rule 211(h)(1)-2. Note that, in addition, proposed rule 211(h)(1)-1 is a definitional rule that would apply to the additional rules adopted under Section 211(h).

6 Rule 206(4)-1, which replaced the old Rule 206(4)-1 (the "advertising rule") and old Rule 206(4)-3 (the "cash solicitation rule").

The rule would also require illiquid funds to provide a simple statement of contributions and distributions, presenting (i) all capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund's inception, with the value and date of each inflow and outflow; and (ii) the net asset value of the private fund as of the end of the reporting period covered by the quarterly statement.

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 lines of credit. It would also require advisers to consolidate reporting for substantially similar pools of assets (such as for parallel funds) to the extent doing so would provide more meaningful information to investors.

The SEC proposes to define "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 and to define "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.

Annual audit requirement

The new rules require registered private fund advisers to obtain an annual audit for each private fund and cause the private fund's auditor to notify the SEC upon certain events.[7] The audit requirement is based on the annual audit requirement that many private funds currently use to comply with the custody rule under the Advisers Act.[8]

The audit must be performed by an independent public accountant subject to standards of independence under Regulation S-X and regular inspection by the Public Company Accounting Oversight Board, and the audit must meet the definition of audit under Regulation S-X. Audited financial statements must be prepared in accordance with U.S. generally accepted accounting principles (GAAP) or, in the case of foreign private funds, must contain information substantially similar to statements prepared in accordance with U.S. GAAP.

Unlike with the custody rule, however, a surprise audit conducted during each calendar year will not meet the proposed annual audit requirement. In addition, the new proposed audit requirement would mandate a written agreement with the auditor, pursuant to which the auditor is required to notify the SEC upon the auditor's termination or issuance of a modified opinion.

Notably, the proposed rules consider, but would not require, that the audit be delivered within 120 days after the end of the fiscal year; instead, the adviser must provide the fund's audited financial statements "promptly" following the audit's completion.

Preferential treatment disclosure

This proposal would prohibit all private fund advisers from providing preferential terms to certain investors regarding redemptions from the fund, an aspect of the reforms that would affect hedge funds in particular.[9]

It would also prohibit an adviser from providing information regarding the portfolio holdings or exposures of the private fund to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.

In addition, the proposed rules would prohibit all fund advisers from providing other preferential treatment unless disclosed to current and prospective investors that often provide more favored rights to certain preferred investors, chiefly through side letters and side arrangements, such as anchor or strategic investors or investors with large commitments. The SEC designed this proposal to protect investors by prohibiting specific types of preferential treatment that have a material, negative effect on other investors, and it explicitly notes by way of example that excuse rights that accommodate one investor's unique investment restrictions may detrimentally affect other investors. In addition, preferential treatment with respect to the payment of carried interest, fee discounts, and co-investment allocations.

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7 Proposed Rule 206(4)-10.

8 Rule 206(4)-2 and, in particular, Rule 206(4)-2(b)(4). The custody rule imposes certain requirements on RIAs with respect to custody of client funds or securities to protect client assets from loss, theft, or misappropriation, including the appointment of a qualified custodian, such as a bank or registered broker-dealer, to maintain client assets and securities. If an RIA, advising a limited partnership or similar pooled investment vehicle subject to audit, provides annually audited financial statements prepared in accordance with U.S. GAAP within 120 days (or 180 day for a fund of funds), the RIA need not comply with other aspects of the custody rule, including notice and quarter statement requirements and a surprise audit requirement.

9 Proposed rule 211(h)(2)-3.

While, in theory, not all side letter provisions would meet the proposed disclosure requirement, an adviser would meet its obligation by providing all investors and prospective investors access to the terms previously granted in the fund's side letters. For advisers engaged in fundraising, the required disclosures would be required prior to a prospective investor's investment in the private fund.

Fairness opinion for secondaries

The new rules require registered private fund advisers, in connection with an adviser-led secondary transaction – when advisers offer existing fund investors the option to sell or exchange their fund interests for interests in another vehicle managed by the adviser – to distribute to investors a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider.[10]

The proposed rules would also require the adviser to prepare and distribute to the investors a summary of any material business relationships the independent opinion provider has or has had within the past two years with the adviser or any of its related persons.

Cybersecurity rules

In a separate release on 9 February, the SEC proposed new rules under the Advisers Act and the U.S. Investment Company Act of 1940 (the Company Act) to require both RIAs and investment companies to adopt and implement written cybersecurity policies and procedures reasonably designed to address cybersecurity risks. [11] The policies and procedures would include certain mandate elements, including:

- a risk assessment in the cybersecurity risks facing an adviser or fund;
- user security and access controls designed to minimize user-related risks and prevent unauthorized access to information and systems, such as (i) an acceptable use policy to require standards of behavior; (ii) two-factor authorization for individual users; (iii) procedures for timely distribution, replacement and revocation of passwords; (iv) restriction of access to specific advise or fund information solely to individuals requiring access as is necessary to perform their duties; and (v) securing remote access technologies;
- policies to monitor and protect information from unauthorized access or use;
- policies designed to detect, mitigate, and remediate cybersecurity threats and vulnerabilities; and
- measures to detect, respond to, and recover from a cybersecurity incident.

The proposed rules would also require RIAs to report significant cybersecurity incidents to the SEC, including on behalf of a private fund client, by submitting Form ADV-C, which unlike other aspects, of Form ADV, would be confidential reports.[12] Nonetheless, the SEC would require the disclosure of cybersecurity risks and incidents to clients and prospective clients though Form ADV Part 2A (commonly known as the "brochure"), which is publicly available.

Conclusion

It has been clear for some time that the SEC, under its new chair Gary Gensler, is seeking to enhance transparency and disclosure for all private fund investors, retail, and institutional alike. The proposed private fund rules, in addition to the proposed Form PF changes and introduction of the cybersecurity rule, take a bold step in that direction.

We will continue to monitor ongoing SEC rulemaking and provide updates as additional proposals emerge and/or the SEC adopts final rules regarding these proposals.

10 Proposed rule 211(h)(2)-2.

11 Proposed rule 206(4)-9 under the Advisers Act and proposed rule 38a-2 under the Company Act.

12 Proposed rule 204-6.

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