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Client Alert

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FINANCIAL SERVICES

Corporate, Finance and Investments

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SEC Issues Significant Private Fund Proposal: Standardized Prohibitions and Requirements

On February 9, in a 3-1 vote, the SEC approved a rule proposal (the "Proposed Rule") that represents a sea-change in the Commission's approach to private funds, with the Proposed Rule including provisions that would impose on private fund advisers certain standardized prohibitions and requirements. These include:

- prohibitions on certain fee and expense arrangements, and other adviser relationships with a private fund and its portfolio investments;
- prohibition on certain types of preferred terms for investors, and required disclosure with respect to other preferential terms;
- an obligation to provide quarterly statements containing specified fee, performance, and portfolio investment information to investors;
- mandatory private fund audits with certain requirements that go beyond the Custody Rule audit provisions;
- fairness opinion requirements for adviser-led secondaries; among other obligations.

Each bullet's clickable link jumps to the related discussion below.

We would highlight the following, in particular, regarding the Proposed Rule:

- The scope of the Proposed Rule is, generally, limited to advisers to "private funds", defined as a 3(c)(1) or a 3(c)(7) fund. As such, as currently drafted, the Proposed Rule would not apply with respect to advisers to "3(c)(5)(C) funds", an exemption relied upon by some real estate funds.[1] However, the SEC has requested comment as to whether it should apply the "quarterly statement" provision of the Proposed Rule to Section 3(c)(5)(C) funds.

- Some provisions of the Proposed Rule apply not only to SEC-Registered Investment Advisers, but also to all investment advisers to private funds, including Exempt Reporting Advisers and state-registered advisers. See the chart at Section VII below for a summary of the same.
- Although not expressly addressed, the proposing release suggests that the Proposed Rule is intended to apply to existing funds.

I. PROHIBITED TERMS AND ARRANGEMENTS

The Proposed Rule would prohibit an investment adviser to a private fund (including Exempt Reporting Advisers and state-registered advisers) from certain practices, in particular with respect to fee and expense reimbursement, regardless of disclosure or investor consent through governing documents or an LPAC. The prohibitions are set forth in the following chart.

Topic	Text of Prohibition	Notes
Accelerated Payments from Portfolio Investments	An investment adviser to a private fund may not, directly or indirectly: *Charge a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment.*	The Proposed Rule would not prohibit the adviser from receiving payment for the noted types of services generally, or from receiving payment in advance for services that it reasonably expects to provide to the portfolio investment in the future (provided that if such services are not ultimately provided, any prepaid amounts are refunded). Rather, the SEC seeks to prohibit “acceleration clauses, which permit the adviser to accelerate the unpaid portion of the fee upon the occurrence of certain triggering events, even though the adviser will never provide the contracted for services”, noting that common triggering events include IPOs, dispositions, and change of control events. The SEC noted that it does not intend the prohibition to apply to advisers that provide a 100% management fee offset for fees received from portfolio companies, subject to conditions.[2]
Reimbursement for Certain Regulatory Fees and Expenses	An investment adviser to a private fund may not, directly or indirectly: *Charge the private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any*	The SEC noted that these proposed prohibitions would not prohibit charging for regulatory, compliance, and other similar fees and expenses directly related to the activities of the private fund. “For example, the proposed rule would not prohibit an adviser from charging a private fund for all the costs associated with a

Topic	Text of Prohibition	Notes
	governmental or regulatory authority. *Charge the private fund for any regulatory or compliance fees or expenses of the adviser or its related persons.*	regulatory filing of the fund, such as Form D," the SEC stated.
Reducing Adviser Clawback for Taxes	An investment adviser to a private fund may not, directly or indirectly: *Reduce 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.*	The SEC would define "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. The SEC would define performance-based compensation as allocations, payments, or distributions of capital based on the private fund's (or its portfolio investments') capital gains and/or capital appreciation.
Limiting or Eliminating Liability for Certain Adviser Misconduct	An investment adviser to a private fund may not, directly or indirectly: *Seek 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, or recklessness in providing services to the private fund.*	
Allocating Fees and Expenses on a Non-Pro Rata Basis Among Funds	An investment adviser to a private fund may not, directly or indirectly: *Charge or allocate fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and*	The SEC noted that this prohibition would apply to allocations of "broken deal" fees and expenses.

Topic	Text of Prohibition	Notes
	other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment.	
Borrowing from the Fund	An investment adviser to a private fund may not, directly or indirectly: *Borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client.*	The proposed prohibition would not prevent the adviser from lending to the fund.

II. RESTRICTIONS ON PREFERENTIAL TERMS FOR FUND INVESTORS

The Proposed Rule would, as described in the below chart:

- prohibit advisers (including Exempt Reporting Advisers and state-registered advisers) from granting certain types of preferential terms to an investor that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets; and,
- require advisers to provide written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons provide to other investors in the same fund.

Type of Preferential Treatment	Rule Impact	Notes
Certain Preferential Redemption Rights: "Grant an investor in the private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets"	Prohibited	The SEC also stated that an adviser would be required to consider whether its proprietary accounts meet the definition of "substantially similar pool of assets."
Certain Preferential Transparency Rights: "Provide information regarding the portfolio holdings or exposures of the private fund, or of a substantially similar pool of assets, to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other	Prohibited.	The SEC also stated that an adviser would be required to consider whether its proprietary accounts meet the definition of "substantially similar pool of assets."

Type of Preferential Treatment	Rule Impact	Notes
investors in that private fund or in a substantially similar pool of assets."		
Other preferential treatment. An investment adviser to a private fund may not, directly or indirectly, provide any other preferential treatment to any investor in the private fund unless the adviser provides written notices as follows: *Advance written notice for prospective investors in a private fund.* The investment adviser shall provide to each prospective investor in the private fund, prior to the investor's investment in the private fund, a written notice that provides specific information regarding any preferential treatment the adviser or its related persons provide to other investors in the same private fund. *Annual written notice for current investors in a private fund.* The investment adviser shall distribute to current investors, on at least an annual basis, a written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided in accordance with this section, if any.	Pre-investment and annual disclosure, as described at left column.	The SEC noted the following as examples of agreements that would constitute preferential treatment requiring disclosure, but would not be prohibited: the right to refrain from participating in a specific investment the private fund plans to make, fee discounts, right to increase investment even if fund is otherwise closed to additional investment. Under the Proposed Rule, the adviser would need to describe specifically the preferential treatment to convey its relevance. The SEC stated, by way of example, that if an adviser provides an investor with lower fee terms in exchange for a significantly higher capital contribution than paid by others, it does not believe that mere disclosure that some investors pay a lower fee is specific enough, but rather than the adviser must describe the lower fee terms, including the applicable rate. The SEC also stated that an adviser could comply with the proposed disclosure requirements by providing copies of side letters (with identifying information regarding the other investors redacted), or by providing a written summary of preferential terms. The SEC expressly stated that it is not proposing to require advisers to disclose the names or types of investors provided preferential terms as part of the proposed disclosure requirement.

III. QUARTERLY STATEMENTS TO INVESTORS

The Proposed Rule would require a Registered Investment Adviser that advises a private fund to prepare a quarterly statement that includes certain information, described in the below chart, regarding fees, expenses, certain portfolio investment relationships, and performance for any private fund that it advises and distribute the quarterly statement to investors within 45 days after each calendar quarter end. The Proposed Rule would not require personalized account statements showing each individual investor's fees, expenses, and performance.

The following chart describes the elements required in the quarterly statement: a "Fund Table" describing all adviser compensation and fund expenses; a "Portfolio Investment Table" identifying each portfolio investment

that has paid compensation to the adviser or a related person in the reporting period; and, certain performance information that varies depending on whether the fund is a liquid fund or illiquid fund.

	Required Content	Notes
Fund Table	The Fund Table must disclose, at a minimum the following information, both before and after any offsets, rebates, or waivers:[3] (1) "Adviser compensation": A detailed accounting of all compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons[4] by the fund during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation (2) "Fund expenses". A detailed accounting of all fees and expenses paid by the private fund during the reporting period (other than those covered by "Adviser compensation" above), with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses. (3) "Offsets or rebates carried forward". The amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the adviser or its related persons.	
Portfolio Investment Table	The quarterly statement must include a separate table for the private fund's covered portfolio investments that discloses, at a minimum, the following information for each: (1) A detailed accounting of all portfolio investment compensation allocated or paid to the investment adviser or any of its related persons by the covered portfolio investment during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, presented both before and after the application of any offsets, rebates, or waivers; and (2) The fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period, or zero, if the fund does not have an ownership interest in the covered portfolio investment, along with a brief description of the fund's investment.	Covered portfolio investment means a portfolio investment that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period. Portfolio investment: means any entity or issuer in which the private fund has directly or indirectly invested. Portfolio investment compensation: means any compensation, fees, and

	Required Content	Notes
		other amounts allocated or paid to the investment adviser or any of its related persons by the portfolio investment attributable to the private fund's interest in such portfolio investment, including, but not limited to, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments.
Performance	The adviser must determine that the private fund is an illiquid <u>fund</u> or a <u>liquid fund</u>, and each quarterly statement would need to present the following with equal prominence depending on the type of fund. <u>Illiquid funds</u>. The following performance measures, shown since inception of the illiquid fund through the end of the quarter covered by the quarterly statement (or, to the extent quarter-end numbers are not available at the time the adviser distributes the quarterly statement, through the most recent practicable date) and computed without the impact of any fund-level subscription facilities: 1. Gross IRR and gross MOIC for the illiquid fund; 2. Net IRR and net MOIC for the illiquid fund; 3. Gross IRR and gross MOIC for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately; and, 4. A statement of contributions and distributions for the illiquid fund. <u>Liquid funds</u>. 1. Annual net total returns for each calendar year since inception;	<u>Illiquid fund</u>: means 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. <u>Liquid fund</u>: means a private fund that is not an illiquid fund.

	Required Content	Notes
	2. Average annual net total returns over the one-, five-, and ten- calendar year periods; and, 3. The cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.	

Other considerations:

- 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.
- The quarterly statement must include prominent disclosure regarding the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated and include cross references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.

IV. MANDATORY PRIVATE FUND ADVISER AUDITS

The Proposed Rule would require SEC-Registered Investment Advisers to private funds to obtain an annual audit of the financial statements of the private funds they manage. Many advisers obtain annual audits as a means to comply with the requirements of the Advisers Act Custody Rule; however, the SEC stated: "[n]ot all advisers are subject to the custody rule and even those that are subject to the custody rule are not required to obtain an audit in order to comply with the rule." The Proposed Rule would also impose additional obligations with respect to a private fund audit, for example, SEC notification requirements in the event of auditor termination.

V. ADVISER-LED SECONDARIES

The Proposed Rule would prohibit a SEC-Registered Investment Adviser that advises private funds from "complet[ing] an adviser-led secondary transaction with respect to any private fund" unless the adviser:

(i) obtains, and distributes to investors in the fund, a fairness opinion from an independent opinion provider; and,

(ii) prepares, and distributes to investors in the private fund, a written 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 prior to the closing of the adviser-led secondary transaction.

"<u>Adviser-led secondary transactions</u>" would be defined 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." The SEC noted in the proposing release that it would generally not view a transaction as initiated by the adviser if the adviser, at the unsolicited request of the investor, assists in the secondary sale of such investor's fund interest. The definition generally would include secondary transactions where a fund is selling one or more assets to another vehicle managed by the adviser, if investors have the option either to obtain liquidity or to roll all or a portion of their interests into the other vehicle.

VI. PROPOSED WRITTEN DOCUMENTATION OF ANNUAL REVIEW OF COMPLIANCE PROGRAMS

Advisers Act Rule 206(4)-7 requires SEC-Registered Investment Advisers to annually review the adequacy of their policies and procedures established to comply with the Advisers Act's provisions and the effectiveness of

their implementation. The SEC has previously stated that such annual review "review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies and procedures."

The SEC noted in the proposing release that its Staff relies on written annual reviews to "understand an adviser's compliance program, determine whether the adviser is complying with the rule, and identify potential weaknesses in the compliance program."

The Proposed Rule would make such written documentation of the annual review mandatory. The SEC noted that the proposed written annual review is meant to be made available to Staff, and thus the SEC takes the view that such reports are not subject to attorney-client privilege.

VII. SUMMARY CHART

Rule Provision	SEC-Registered Investment Advisers That Advise a Private Fund	Exempt Reporting Advisers That Advise a Private Fund	State-Registered Advisers that Advise a Private Fund	SEC-Registered Investment Advisers That Do Not Advise Private Funds
Quarterly Statement Obligations	✓			N/A
Prohibited Terms and Arrangements Between Fund and Adviser	✓	✓	✓	N/A
Preferential Treatment Restrictions	✓	✓	✓	N/A
Annual Audit of Private Fund	✓			N/A
Fairness Opinion for Adviser-Led Secondaries	✓			N/A
Written Documentation of Annual Compliance Review	✓			✓

VIII. NEXT STEPS

The public comment period for the Proposed Rule is scheduled to close 30 days following the proposal's publication in the Federal Register (which has not occurred as of the date of this alert) or April 11, 2022, whichever is later. The proposing release proposes a one-year transition period for advisers to come into compliance with the rules, following the rules' effective dates, which would be sixty days after the rules' publication in the Federal Register.

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[1] Section 3(c)(5)(C) of the Investment Company Act provides an exclusion from the definition of investment company for any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

[2] The SEC noted, however, that "private funds with a 100% management fee offset would not comply with the proposed rule if there are excess fees retained by the adviser where no further management fee offset can be applied and the private fund investors are not offered a rebate or another economic benefit equal to their pro rata share of any such excess fees."

[3] Offsets, rebates, and waivers applicable to certain, but not all, investors through one or more separate arrangements would be required to be reflected and described prominently in the fund-wide numbers presented in the quarterly statement. See proposed rule 211(h)(1)-2(d) and (g).

[4] "Related persons" includes: (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.