A Transformation in SEC Regulation of Private Fund Managers

Akin Gump
STRAUSS HAUER & FELD LLP

February 16, 2022

A Business-Friendly Compendium of Recent SEC Actions and Proposals

Disclaimer

The information in this presentation is intended to provide a high-level summary and general overview of the subject matter for discussion purposes and may not be relied upon by any party for any purpose. The information is not intended to be comprehensive and does not constitute, and should not be taken to be, legal, or any other form of, advice. If you wish to obtain legal advice or further information on any issue raised by this briefing, please get in touch with one of your usual contacts at Akin Gump Strauss Hauer & Feld LLP.

Topics

Overview

A Significant Transformation in SEC Regulation

In recent weeks, the U.S. Securities and Exchange Commission (the "SEC") has kicked off a wholesale transformation in the regulation of the private funds industry. These actions include rule proposals, enforcement actions, and SEC Staff guidance that, taken together, represent a shift to direct regulation on a scale never seen before in this segment of the industry.

- On January 26, 2022, the SEC proposed amendments to Form PF, *Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers* (the "Form PF Proposal"), that will require near-real time SEC reporting of adverse events.
- On January 27, 2022, the SEC Division of Examinations issued a Risk Alert, *Observations from Examinations of Private Fund Advisers* (the "Risk Alert"), outlining common deficiencies.
- On February 9, 2022, the SEC proposed new and amended rules under the Investment Advisers Act of 1940 that would change the amount of direct supervision and regulation applicable to private fund managers:
  - *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews* (the "Private Funds Proposal"); and
  - *Cybersecurity Risk Management For Investment Advisers, Registered Investment Advisers, Registered Investment Companies and Business Development Companies* (the "Cybersecurity Proposal").
- On February 10, 2022, the SEC proposed amended ownership reporting rules under the Securities Exchange Act of 1934, *Modernization of Beneficial Ownership Reporting* (the "Reporting Proposal").
- On December 15, 2021, the SEC proposed new rules under the Securities Exchange Act of 1934 that would require the reporting of large swap positions and prohibit fraud, manipulation or deception in connection with security-based swaps (the "Large Swaps Position Reporting Proposal").

Use of this Presentation

To aid our clients and friends in preparing for these impending changes, this presentation provides highlights of some key points of the SEC's proposals and other transformative actions. It is intended to provide legal and compliance personnel, as well as investment and operations personnel, with a practical way to understand how the SEC's rapidly evolving regulatory agenda will impact private fund managers.

While it is too early to predict exactly what steps will be required, we do expect most of the proposed changes to be adopted. As a result, it is likely that all private fund managers will need to take at least some of the following steps:

- Specific assessments of the impact of these proposed changes on their businesses;
- Careful and extensive reviews of offering documents, fund organizational documents, and management agreements;
- Discussions with investors and clients on the impending changes; and
- Reviews of staffing levels in and other resources available to legal and compliance departments.

Unlike many rulemakings, some of these momentous changes apply to investment advisers that are not required to be registered with the SEC (e.g., exempt reporting advisers), so these actions will need to be undertaken by a large number of managers.

“Hedge Clauses,” Liability Limitations, and Fiduciary Status

Hedge Clauses and Fiduciary Standards

"Hedge clauses" (provisions in an advisory agreement that purport to limit an adviser's liability) are a direct focus of the Risk Alert and also of the Private Funds Proposal's "Prohibited Activities" (the "Prohibited Activities Proposal").

- The Risk Alert cited advisers that included "potentially misleading hedge clauses" that "purported to waive or limit the Advisers Act fiduciary duty except for certain exceptions."
- The SEC also recently brought an enforcement action against an investment adviser premised on allegations that a "hedge clause" misled retail clients.

This focus is based on the SEC's view that advisers are subject to a "federal fiduciary duty" and language in the 2019 Fiduciary Interpretation, which acknowledged that a manager's "fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client" but expressly prohibited, "regardless of the sophistication of the client," contract provisions such as:

- a statement that an adviser will not act as a fiduciary;
- a blanket waiver of all of an adviser's conflicts of interest; and
- a waiver of any specific obligation under the Advisers Act.

Comprehensive Capital

In the recent *Comprehensive Capital Management* case, the SEC took issue with a limitation of liability utilized in investment management agreements with retail clients.

- The hedge clause (revised after an earlier version was criticized on examination) stated that the adviser:
  - "will be liable only for … acts of gross negligence or willful misconduct;"
  - "will not be liable for any act or omission by brokers or other agents selected with "reasonable care;" and
  - "will not be liable for any incidental, indirect, special, punitive or consequential damages,"

  subject to a savings clause stating that federal and state securities laws may "impose liability on persons who act in good faith and nothing in this Agreement shall serve to waive or limit any rights Client may have under those laws."
- The SEC determined that the agreement's hedge clause was "inconsistent with an adviser's fiduciary duty" and with the Fiduciary Interpretation "because it may mislead CCM's retail clients into not exercising their legal rights."
- The SEC order also asserted that the agreement's statement that CCM will be liable only for its "own acts of gross negligence or willful misconduct" was "an inaccurate statement of the liability standards under the federal securities laws as they apply to investment advisers" and, accordingly, violated Section 206(2) of the Advisers Act.

While the SEC order emphasized the fact that CCM's client base was primarily retail, the prohibitions in the Prohibited Activities Proposal *would not be limited to retail clients*.

Prohibited Activities Proposal

The positions taken in *Comprehensive Capital* were echoed in the January Risk Alert, where the Division of Examinations asserted that:

> *Whether a clause in an agreement, or a statement in disclosure documents provided to clients and investors, that purports to limit an adviser's liability (a "hedge clause") is misleading and would violate Sections 206(1) and 206(2) of the Advisers Act depends on all of the surrounding facts and circumstances. EXAMS staff observed private fund advisers that included potentially misleading hedge clauses in documents that purported to waive or limit the Advisers Act fiduciary duty except for certain exceptions, such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud. Such clauses could be inconsistent with Sections 206 [an anti-fraud provision] and 215(a) [validity of contracts that purport to effect impermissible waivers] of the Advisers Act.*

This focus on narrowing hedge clauses and agreed-upon limitations on liability ultimately culminated in the Prohibited Activities Proposal, which proposes a categorical prohibition on manager from 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, or recklessness.*

Implications and Next Steps

Implications

- Expect intense SEC focus on all hedge clauses and liability limitations.
- Prepare for a special focus on hedge clauses in IMAs with retail clients, but note that the Prohibited Activities Proposal would apply to all clients.
- The Prohibited Activities Proposal could have a large impact on insurance products for managers, in terms of impacting both the cost and the availability of liability insurance products.
- The Prohibited Activities Proposal could result in a potential private right of action in contract law.

Next Steps

- Identify all hedge clauses and limitations of liability in fund PPMs, LPAs and other constituent agreements.
- Review all investment management agreements with retail clients.
- Consider communicating the adverse impacts on the industry and investors from adoption of the Prohibited Activities Proposal.

Prohibited Activities

Prohibited “Preferential Treatment”

The SEC believes that increased transparency “would better inform investors regarding the breadth of preferential treatment, the potential for those terms to affect their investment in the private fund, and the potential costs (including compliance costs) associated with these preferential terms.”

Under the Prohibited Activities Proposal, all private fund advisers (including exempt reporting advisers) would be *prohibited* (irrespective of disclosures or investor agreements) from providing preferential terms like the following to certain investors:

- *Redemption/Liquidity.* Private fund advisers would be prohibited from granting 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 the other investors.
- *Transparency.* Private fund advisers would be prohibited from providing information regarding portfolio holdings or exposures of the fund if the adviser “reasonably expects to have a material, negative effect” on the other investors.

Other Preferential Treatment Requires Disclosure. Private fund advisers would be prohibited from providing any other preferential treatment to any investor in the private fund or in a substantially similar pool of assets unless the adviser provides detailed written disclosures (for example, specific ranges of fee discounts) to prospective and current investors in a private fund. In proposing this change, the SEC noted with approval the effect of the EU Alternative Investment Fund Managers Directive (AIFMD)’s preferential treatment disclosure requirements on side letter practice.

(Of course, whether any terms are “preferential” would depend on the facts and circumstances.)

Prohibited Financial Transactions

The Prohibited Activities Proposal would also prohibit all private fund advisers (including exempt reporting advisers) from engaging in a number of activities and practices (which the SEC has deemed to be “contrary to the public interest and the protection of investors”), including:

- Charging accelerated monitoring fees and other fees for unperformed services;
- Passing through fees and expenses associated with an examination of the adviser or its related persons;
- Passing through fees and expenses associated with an investigation of the adviser or its related persons;
- Charging the private fund for any regulatory or compliance fees or expenses of the adviser or its related persons;
- Seeking reimbursement, indemnification, exculpation, or limitation of its liability for certain activity (discussed below);
- Reducing the amount of an adviser clawback by the amount of certain taxes;
- Charging fees or expenses related to a portfolio investment on a non-pro rata basis; and
- Borrowing or receiving an extension of credit from a private fund client.

Implications and Next Steps

Implications

- Implementation of the Prohibited Activities Proposal will have obvious direct effects on managers, but could also have unintended adverse direct and indirect effects on investors.
- These proposed changes could necessitate changes in an adviser's overall compensation arrangements.

Next Steps

- Review the list of prohibited activities and transactions and compare them to an adviser's current practices.
- Seek to quantify the effects of the proposed prohibitions coming into force.
- Assess whether any of the prohibited activities would prevent or disincentivize a private fund manager from taking steps that would benefit investors.

Quarterly Statements – Fee and Expense Disclosures

Quarterly Fee and Expense Disclosures

In the Private Funds Proposal, the SEC claimed that investors "often lack transparency regarding the total cost" of private fund fees and expenses. Accordingly, the proposal requires registered private fund advisers to prepare and distribute a quarterly statement to private fund investors, generally within 45 days after each quarter end, showing:

- *Adviser Compensation*: A detailed accounting (i.e., separate line items) of compensation, fees and other amounts allocated or paid to the adviser and its "related persons."
- *Fund Expenses*: A detailed accounting (again, separate line items) of other fees and expenses paid by the private fund.
- *Offsets, Rebates and Waivers*: Disclosures reflecting adviser compensation and fund expenses before and after the application of any offsets, rebates or waivers.
- *Portfolio Investment Compensation*: A detailed accounting of all portfolio company/investment compensation allocated or paid (directly or indirectly) to an adviser or its related persons.
- *Private Fund Ownership*. The private fund's ownership percentage of each covered portfolio company/investment.

The proposed quarterly statement rule would also require:

- Prominent disclosure of calculation methodologies; and
- Cross references to the relevant sections of the private fund's offering and constituent documents.

The reporting would be done at the private fund or portfolio investment level (and not on an investor-by-investor basis).

Performance Disclosures

The Private Funds Proposal also requires quarterly private fund performance disclosures:

- *Illiquid funds:* Performance based on the internal rate of return and a multiple of invested capital.
  - The SEC proposed to define an "illiquid fund" as any private fund with a limited life span, limited capital raising period, and a predominant strategy of returning disposition proceeds to investors that does not routinely acquire market-traded securities and derivative instruments.
  - Closed-end funds that do not offer periodic redemption rights generally fall under "illiquid funds."
- *Liquid Funds:* Performance based on net total return on an annual basis since the fund's inception, over prescribed time periods and on a quarterly basis of the current year.
  - The SEC proposed to define a "liquid fund" as "any private fund that is not an illiquid fund."

The SEC noted that information in the quarterly statements would not be considered an "advertisement" under the marketing rule, but an adviser offering "new or additional investment advisory services in regard to the securities in the quarterly statement would need to consider whether such information would be subject to the marketing rule."

Next Steps

Immediate Next Steps

- Managers should review all fee and expense items to determine the impact of broad disclosures.
- Compensation at all levels should be reviewed, including compensation received by entities that may or may not be deemed to be affiliates.

Broader Actions

- Consider whether these proposed disclosures raise contractual, trade secret or other legal concerns for the manager of the funds.
- Determine whether there are unanticipated negative effects on investors that should be brought to the SEC's attention.
- Consider engaging with the SEC on its questions of:
  - Should there be investor-specific disclosures?
  - Should different economic arrangements be disclosed in the quarterly statements?
  - Should this be applied to all advisers (not just RIAs)?
  - Should the SEC consider alternative approaches, such as prohibiting the "2 and 20" model? Or compensation from portfolio companies?

New Audit Requirement

Broader Audit Rule

The Private Funds Proposal would require registered private fund advisers to deliver an annual (and upon liquidation) financial statement audit. This is intended to protect private fund investors against misappropriation of fund assets and to “provide an important check on the adviser’s valuation of private fund assets, which often serve as the basis for the calculation of the adviser’s fees.”

Implications

- While based on the Custody Rule, compliance with that rule would not satisfy the requirements of this proposal (and vice versa).
- May effectively end use of the “surprise examination.”
- Auditor required to notify the Division of Examinations upon the auditor’s termination or issuance of a modified opinion (including a qualified opinion, an adverse opinion and a disclaimer of opinion).

Next Steps

- Managers should determine whether this rule will impose additional costs on investors.

Written Annual Compliance Review

Written Annual Compliance Review

The Private Funds Proposal would revise Rule 206(4)-7(b), as follows, to require that the annual review be in writing:

> *Annual review. Review and document in writing, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation*

Implications

- It will now be essential that all annual reviews are in writing and available to the SEC upon request.
- Any advisers that depend on an oral presentation of the annual review would need to ensure that they also create and retain adequate written documentation of the review).

Next Steps

- Ensure that the annual review (including the written report) is on an annual cycle.
- Ensure that the annual review written report documents both (i) adequacy of policies and (ii) effectiveness of implementation.

Focus on Adviser-Led Secondaries

Adviser-Led Secondaries Rule

The Private Funds Proposal contains an “Adviser-Led Secondaries Rule” that requires a registered private fund adviser to provide investors with:

- *A fairness opinion* from an independent provider would opining on the fairness of the price being offered and
- *A material business relationships summary* summarizing 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 SEC believes that this rule would provide a check against “an adviser’s conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors.”

The SEC has requested for comments, including the scope of the rule and the definitions and whether the fairness opinion should be distributed to investors or only upon request.

Implications and Next Steps

Implications

- Under the Adviser-Led Secondaries Rule, a competitive sales process would not exempt the adviser from a obtaining a fairness opinion.
- Industry participants would need to coordinate with an independent provider in order for the fairness opinion to be shared with the fund's investors.
- LPAC approval and processes would be dependent on the fairness opinion, which would not necessarily provide the highest value to fund's selling investors.
- Proposed rule is not sufficiently clear as to the scope of the fairness opinion and types of transactions covered.
- Proposed rule does not address sponsor liability in the event transactions proceed despite an unfavorable opinion or if one is not able to be obtained.

Next Steps

- Consider whether a fairness opinion addresses the concerns raised by the SEC or whether alternative approaches, such as competitive sales processes and LPAC approvals mitigate conflicts.
- Consider whether the proposed rule provides adequate clarity on the scope of the fairness opinion in light of the nature of the particular advisor-led secondary.
- Consider whether independent providers would be in a position to share fairness opinions as described in the Adviser-Led Secondaries Rule.

Recordkeeping Changes

Recordkeeping Changes

The Private Funds Proposal would amend the recordkeeping rule to accommodate the new documentation requirements (e.g., under the quarterly fee and expense statements, audits, adviser-led secondaries, and preferential treatment proposals).

Implications

- The SEC asked for comment on whether the books and records rule should require not only registered investment advisers but also other advisers such as exempt reporting advisers to retain written notices in relation to the above-listed rules.

Next Steps

- For RIAs: Ensure that the new requirements dovetail with existing systems and processes.
- For ERAs: Consider the effect on the business from new requirements. Consider whether SEC outreach in the form of a comment letter is warranted.

The Form PF Proposal

Proposed Form PF Changes

The Form PF Proposal would change the reporting obligations by, among other things, expanding the scope of information required to be reported by large private equity fund advisers and large liquidity fund advisers.

In particular, the Form PF Proposal would amend the Form PF to require the reporting of adverse events, generally on a one business day requirement, to the SEC:

Private Equity Managers

More information required on

- Fund strategies;
- Leverage;
- Portfolio company financings and borrowings;
- Investments in different levels of the capital structure of a portfolio company; and
- Portfolio company restructurings or recapitalizations.

Hedge Fund Managers

- Extraordinary (i.e., 20% in ten days) investment losses;
- Significant margin/counterparty default events and other changes in prime broker relationships;
- Changes in unencumbered cash;
- Operations events; and
- Certain withdrawal and redemption events.

Implications and Next Steps

Implications

- This is expected to result in private fund managers adopting an "8-K style culture," although the filing period is one business day as opposed to four business days for 8-Ks.
- The SEC enumeration of investments at different levels of a capital structure portends an enhanced SEC focus on conflicts arising from such multi-tier investments in the same portfolio company.
- For private equity managers, the reporting threshold drops from $2 to $1.5 billion in private equity fund assets under management.

Next Steps

- Fund managers should consider implementing operation and reporting controls to capture the occurrence of report triggering events and a filing process to promptly make the filing.
- Fund managers should consider how the increased cost of these filings will be accounted if the Private Fund Proposal is adopted in a manner that prohibits fund managers from passing along their compliance costs to their fund clients.
- In light of disclosure regarding investments at different levels of a capital structure, fund managers should apply increased conflicts and compliance analysis to any such investments as they may be an exam focus or even an exam prompt for the SEC.

Proposed Cybersecurity Rules

Annual Review

The Cybersecurity Proposed Rules would require registered investment advisers to, at least annually:

- Review and assess the design and effectiveness of their cybersecurity policies and procedures.
- Prepare a written report, which would:
  - describe the annual review, assessment and any control tests performed; and
  - explain the results.
- Document any cybersecurity incident that occurred since the date of the last report.
- Discuss any material changes to the policies and procedures since the date of the last report.

Reporting

The Cybersecurity Proposed Rules would include a new reporting rule requirement and related proposed Form ADV-C which would be require an adviser to report significant cybersecurity incidents to the SEC.

- An adviser would be required to submit proposed Form ADV-C promptly but in no event more than 48 hours after having a reasonable basis to conclude that a “significant adviser cybersecurity incident” had occurred or is occurring.
- “*Significant adviser cybersecurity incident*” would be defined as: “a cybersecurity incident, or a group of related incidents, that significantly disrupts or degrades the adviser’s ability, or the ability of a private fund client of the adviser, to maintain critical operations, or leads to the unauthorized access or use of adviser information, where the unauthorized access or use of such information results in: (1) substantial harm to the adviser, or (2) substantial harm to a client, or an investor in a private fund, whose information was accessed”.
- Form ADV-C would be confidential and not available to public disclosure.

However, the rule would amend Form ADV Part 2A to require (public) disclosure of cybersecurity risks and incidents that could materially affect the advisory relationship.

Recordkeeping

The Cybersecurity Proposed Rules would amend the books and records rule to require advisers to maintain:

- Copy of their cybersecurity policies and procedures in effect and any time within the past five years
- Copy of the adviser’s written report documenting the annual review in the last five years
- Copy of any Form ADV-C filed by the adviser in the last five years
- Records documenting the occurrence of any cybersecurity incident
- Records documenting the occurrence of a cybersecurity incident may include event or incident logs.

Cybersecurity Proposed Rule Changes

Implications

- Cybersecurity assessments will be incorporated into written annual reviews.
- Formalized, practiced incident response will be critical to timely comply with the Form ADV-C requirement as currently proposed.
- Close review of third-party incidents will be essential for compliance.

Next Steps

- Managers should review and revise their incident response plans and other cybersecurity policies and procedures.
- Managers should also consider establishing and reviewing cybersecurity incident log, including events from third parties.
- Managers should also evaluate third-party contracts to ensure contractual commitments that would enable timely reporting to the SEC.
- Managers should conduct a tabletop exercise to ensure familiarity with the plan and establish ability to report within 48 hours to the SEC.
- Managers should consider what incidents would “lead to the unauthorized access or use of adviser information” and how to effectively respond to such incidents.

The Beneficial Ownership Proposal

Accelerated Timing

The Beneficial Ownership Proposal would dramatically shorten deadlines for Schedule 13D and Schedule 13G filings:

Issue	Current Schedule 13D	Proposed New Schedule 13D	Current Schedule 13G	Proposed New Schedule 13G
Initial Filing Deadline	Within 10 days after acquiring beneficial ownership of more than 5% or losing eligibility to file on Schedule 13G. Rules 13d-1(a), (e), (f) and (g).	Within five days after acquiring beneficial ownership of more than 5% or losing eligibility to file on Schedule 13G. Rules 13d-1(a), (e), (f) and (g).	<u>Qualified Institutional Investors & Exempt Investors:</u> 45 days after calendar year-end in which beneficial ownership exceeds 5%. Rules 13d-1(b) and (d). <u>Passive Investors:</u> Within 10 days after acquiring beneficial ownership of more than 5%. Rule 13d-1(c).	<u>Qualified Institutional Investors & Exempt Investors:</u> Five business days after month-end in which beneficial ownership exceeds 5%. Rules 13d-1(b) and (d). <u>Passive Investors:</u> Within five days after acquiring beneficial ownership of more than 5%. Rule 13d-1(c).
Amendment Triggering Event	Material change in the facts set forth in the previous Schedule 13D. Rule 13d-2(a).	No amendment proposed – material change in the facts set forth in the previous Schedule 13D). Rule 13d-2(a).	<u>All Schedule 13G Filers:</u> Any change in the information previously reported on Schedule 13G. Rule 13d-2(b). <u>Qualified Institutional Investors & Passive Investors:</u> Upon exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership. Rules 13d-2(c) and (d).	<u>All Schedule 13G Filers:</u> Material change in the information previously reported on Schedule 13G. Rule 13d-2(b). <u>Qualified Institutional Investors & Passive Investors:</u> No amendment proposed – upon exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership. Rules 13d-2(c) and (d).

Accelerated Timing *(cont'd)*

Issue	Current Schedule 13D	Proposed New Schedule 13D	Current Schedule 13G	Proposed New Schedule 13G
Amendment Filing Deadline	Promptly after the triggering event. Rule 13d-2(a).	Within one business day after the triggering event. Rule 13d-2(a).	<u>All Schedule 13G Filers:</u> 45 days after calendar year-end in which any change occurred. Rule 13d-2(b). <u>Qualified Institutional Investors:</u> 10 days after month-end in which beneficial ownership exceeded 10% or there was, as of the month-end, a 5% increase or decrease in beneficial ownership. Rule 13d-2(c). <u>Passive Investors:</u> Promptly after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership. Rule 13d-2(d).	<u>All Schedule 13G Filers:</u> Five business days after month-end in which a material change occurred. Rule 13d-2(b). <u>Qualified Institutional Investors:</u> Five days after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership. Rule 13d-2(c). <u>Passive Investors:</u> One business day after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership. Rule 13d-2(d).
Filing "CutOff" Time	5:30 p.m. eastern time. Rule 13(a)(2) of Regulation S-T.	5:30 p.m. eastern time. Rule 13(a)(2) of Regulation S-T.	<u>All Schedule 13G Filers:</u> 5:30 p.m. eastern time. Rule 13(a)(2) of Regulation S-T.	<u>All Schedule 13G Filers:</u> 10 p.m. eastern time. Rule 13(a)(4) of Regulation S-T.

Excerpted from Securities Act Release 11028, "Modernization of Beneficial Ownership Reporting" (February 10, 2022). "Qualified Institutional Investors" consist of RIAs, registered investment companies and other institutions holding securities in the ordinary course of business without the purpose or effect of influencing control of the issuer. "Exempt investors" generally consist of persons who acquired securities before the issuer became a public company.

Substantive Provisions—Derivatives

The Beneficial Ownership Proposal also expands the regulatory obligations by including holders of certain derivatives to be deemed beneficial owners and therefore subject to Schedule 13D/G reporting and/or Section 16.

Inclusion of Derivatives. Holders of certain cash-settled derivative securities “deemed” beneficial owners of the reference equity securities.

- Proposed new Rule 13d-3(e) would provide that a holder of a cash-settled derivative security, other than a security-based swap, will be deemed the beneficial owner of the reference equity securities if the derivative is held:
  - with the purpose or effect of changing or influencing the control of the issuer of the reference securities, or
  - in connection with or as a participant in any transaction having such purpose or effect.
- In addition, the proposed amendments would revise Item 6 of Schedule 13D to clarify that a person is required to disclose interests in <u>all derivative securities</u> (including cash-settled derivative securities and securities-based swaps) that use the issuer’s equity security as a reference security.

Substantive Provisions—Groups

The Beneficial Ownership Proposal clarifies what constitutes a “group.”

Group Status implicated in certain circumstances, including:

- expanding group concepts beyond situations in which persons agree to act together to include where persons “act” together as a group;
- “tipper-tippee” relationships where advance 13D filing information is shared with a subsequent purchaser;
- new exemptions to permit investors to communicate and consult with each other, jointly engage with issuers, and execute certain transactions without being subject to regulation as a group:
  - communications without the purpose or effect of changing or influencing control of the issuer and
  - investors and financial institutions enter into agreements governing the terms of derivative securities.

Implications and Planning

As noted above, the Beneficial Ownership Proposal will dramatically impact the reporting framework.

These proposed rule changes would appear to alter the careful balance previously struck between the interests of disclosing a large investor's holdings to the public and the incentives for investors to capitalize on their investment decisions. It also alters the traditional definition of beneficial ownership as provided under Section 13(d) of the Securities and Exchange Act of 1934, by including cash-settled derivative securities (other than securities-based swaps) in the definition of disclosable securities for active investors filing on Schedule 13D. If these rules are passed as proposed, managers will have to carefully scrutinize their internal investment and disclosure procedures to acclimate to this new regime.

Implications

- Managers will be subject to shortened reporting deadlines and accordingly will need to update their compliance processes.
- Managers will need to assess whether certain derivative positions will need to be reported under the Beneficial Ownership Proposal.

Next Steps

- Consider the infrastructure needed to ensure compliance with the Beneficial Ownership Proposal.
- Consider engaging with the SEC regarding the timing of the reporting obligations.

The Large Swaps Position Reporting Proposal

Reporting of Large Security-Based Swap Positions

Proposed Rule 10B-1 under the Securities Exchange Act of 1934 would require any person (including its affiliates and group members) with a security-based swap position that exceeds the reporting threshold to publicly file a report on EDGAR by no later than the end of the first business day following the execution of the security-based swap transaction that results in exceeding the relevant reporting threshold amount.

Amendments are also required to be filed for material changes by the end of the first business day following the material change, including any material increase in the position (10% or more) or a decrease resulting in falling below the reporting threshold.

Schedule 10B would require disclosure of the identity of the reporting person and position and the underlying securities.

Security-based swap positions include swaps based on an individual security or loan or a narrow-based securities index or any interest therein or based on the value thereof.

Thresholds—Debt

Swap Type	Threshold
Credit default swaps (including those based on a narrow-based index)	The lesser of: • A long notional amount of $150 million, calculated by subtracting the notional amount of any long positions in a deliverable debt security underlying a security-based swap from the long notional amount. • A short notional amount of $150 million. • A gross notional amount of $300 million.
Security-based swap positions based on debt securities that are not CDS	Gross notional amount of $300 million.

Thresholds—Equity

Swap Threshold Type	Threshold

Notional threshold	• Gross notional threshold of $300 million.
	• If the gross notional amount of the security-based swap position exceeds $150 million, then the calculation shall also include the value of:
	    • the underlying equity securities.
	    • the delta-adjusted notional amount of any options, security futures or other derivative instruments based on the same class of equity securities.

Percentage of outstanding	• The security-based swap equivalent position represents more than 5% of a class of equity securities. • If the security-based swap equivalent position exceeds 2.5% of a class of equity securities, then the calculation shall also include the underlying equity securities and the shares attributable to any options, security futures or other derivative instruments based on the same class of equity securities.

Implications and Planning

As noted above, the Large Swaps Positions Reporting Rule would for the first time require public reporting of significant swaps positions. If adopted as proposed, managers would need to consider whether to limit their positions in the future if they wish to avoid public reporting.

Implications

- Managers would be subject to a new public reporting regime and accordingly would need to update their compliance processes.

Next Steps

- Consider the infrastructure needed to ensure compliance with Rule 10B-1.
- Consider engaging with the SEC regarding the timing of the reporting obligations.

Next Steps

Next Steps

These proposed SEC actions represent a generational shift in regulation of private funds managers. Each manager will have to consider whether and how to respond to these proposals.

There are a number of steps that managers can take, including:

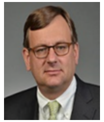
- Discussing the costs and effort required to implement these actions with other managers.
- Engaging in similar discussions with investors.
- Becoming involved in the comment process, either directly, through an industry organization, or through counsel.
- Reviewing budgets, staffing and other resource needs implicated by the SEC proposals.

It is clear that change is coming to the private funds industry. The question for each manager is how it will respond to these impending changes.

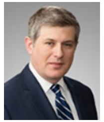
Key Contacts

Key Contacts

Regulatory & Compliance – Investment Adviser


JP Bruynes
New York


Brian Daly
New York


Jason Daniel
Dallas


Alexandra Delman
New York


Anne-Marie Godfrey
Hong Kong


Barbara Niederkofler
New York


Stephen Vine
New York


Jenny Walters
Dallas

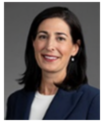
Securities Enforcement and Litigation

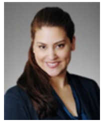

Peter Altman
Los Angeles


Mike Asaro
New York


Jim Benjamin
New York

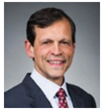

Chuck Connolly
Washington, D.C.


Katie Goldstein
New York

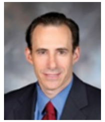

Natasha Kohne
San Francisco


Helen Marshall
London

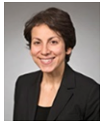

Ian McGinley
New York


Claudius Modesti
Washington, D.C.


Parvin Moyne
New York


Douglas Rappaport
New York

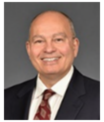

Michelle Reed
Dallas

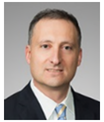

Ezra Zahabi
London

Key Contacts *(cont'd)*

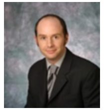
Investment Management


Olivia Chung
Singapore


John Daghlian
London


Jim Deeken
Dallas


Mike DiLernia
New York


Christopher Gorman-Evans
London


Blayne Grady
Washington, D.C.


Bob Griffin
Dallas

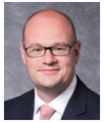

John Hamilton
New York


Adam Hilkemann
Dallas


John Holton
London


Mary Lavelle
London


Arina Lekhel
New York

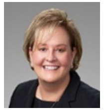

Ian Meade
London


Prakash Mehta
New York


Kapil Pandit
Washington, D.C.


Tim Pearce
London


Dennis Pereira
New York


Lisa Peterson
Fort Worth

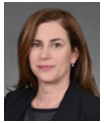

Daniel Quinn
London


Eliot Raffkind
Dallas


Jonathan Ross
New York


Terence Rozier-Byrd
New York


Fadi Samman
Washington, D.C.


Ann Tadajweski
New York