SEC Proposes Substantial Changes to Private Fund Regulatory Regime

Authored by Sonia Gioseffi, Tricia Lee, Omoz Osayimwese, Mark Perlow, Kenneth Rasamny, Michael Sherman, Timothy Spangler, Lindsay Trapp, Ashley Rodriguez, Phillip Garber and Sarah Sennett

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Dechert LLP

Table of Contents

Introduction 1

Quarterly Statements 3

Private Fund Audits 7

Adviser-Led Secondaries 8

Certain Other Prohibited Activities 9

Preferential Treatment and Restrictions on Side Letters 11

RIA Annual Compliance Reports 12

Potential Implications 13

Next Steps 13

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Introduction

The Securities and Exchange Commission on February 9, 2022, voted three to one to propose a set of new rules and rule amendments under the Investment Advisers Act of 1940 that collectively, if adopted, would represent the most significant changes to the regulation of private funds and their advisers since the Dodd-Frank Act.[1] These proposed rules would:

- *Quarterly Statements*: Require private fund advisers that are registered or required to be registered with the SEC (Private Fund RIAs) to provide investors with quarterly statements that include significant detail as to the fund's performance and fees and expenses;
- *Private Fund Audits*: Require Private Fund RIAs to obtain an annual audit of each private fund, and cause the private fund's auditor to notify the SEC upon the occurrence of certain events;
- *Adviser-Led Secondaries*: In connection with adviser-led secondaries, require Private Fund RIAs to obtain a fairness opinion and distribute it to investors, along with a summary of material business relationships between the Private Fund RIA and the opinion provider;
- *Certain Other Prohibited Activities*: Prohibit all advisers to private funds (including Private Fund RIAs, exempt reporting advisers, foreign private advisers, state-registered advisers and certain other investment advisers that are not required to be SEC-registered pursuant to Section 203(b) of the Advisers Act,

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[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Proposed Rule, SEC Rel. No. IA-5955 (Feb. 9, 2022) (Release); Dodd-Frank Wall Street Reform and Consumer Protection Act, section 913(h), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (Dodd-Frank Act). At times, this *NewsFlash* tracks the language in the Release, and quotations in this *NewsFlash* refer to the Release unless otherwise noted.

A Private Fund RIA: is an SEC-registered investment adviser or required to be so registered (including any adviser that also is registered or required to register with the CFTC as a commodity pool operator (CPO) or commodity trading advisor (CTA)); and that advises an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that act (private fund). *See* Form PF: Glossary of Terms (defining private fund adviser and private fund). This *NewsFlash* also uses the term "Private Fund Adviser" herein which term includes Private Fund RIAs as well as those advisers which are exempt reporting advisers, foreign private advisers, state registered advisers and others not required to be SEC-registered. The term "RIA" herein indicates any SEC-registered investment adviser (regardless of the types of accounts they manage) and including those required to be so registered. It includes "Private Fund RIAs" as that term is used herein.

As proposed, a CLO would be considered a private fund for purposes of the proposed rule to the extent that the CLO is unable to rely on Section 3(c)(5) of, or Rule 3a-7 under, the 1940 Act. As a result, collateral managers should consider how they would comply with the proposed rule in light of the particular structure of CLOs.

collectively, Private Fund Advisers) from engaging in certain activities (e.g., related to certain sales practices, conflicts of interest, expenses charged to private funds and compensation arrangements);

- *Preferential Treatment and Restrictions on Side Letters*: Prohibit all Private Fund Advisers from engaging in certain types of differential treatment of investors (i.e., entering into side letters in respect of certain preferential redemption rights or providing preferential information where there is a reasonable expectation such treatment could have "a material, negative effect" on investors), while prohibiting other types of differential treatment absent disclosure to current and prospective investors;

- *RIA Annual Compliance Reports*: Require each investment adviser that is registered or required to be registered under the Advisers Act (RIA) to prepare a written report of its annual compliance program review, which the SEC intends would "focus renewed attention on the importance of the annual compliance review process" and assist examinations staff; and

- *Recordkeeping Amendments*: Make corresponding amendments to Advisers Act Rule 204-2 (Recordkeeping Rule) to require RIAs to make and maintain records related to certain of the newly proposed requirements.[2]

In the Release, the SEC stated that the "goal of this package of proposed reforms is to protect those who directly or indirectly invest in private funds by increasing visibility into certain practices, establishing requirements to address certain practices that have the potential to lead to investor harm, and prohibiting adviser activity that we believe is contrary to the public interest and the protection of investors." In the press release introducing the proposal, SEC Chair Gensler stated that "it's worth asking whether we can promote more efficiency, competition, and transparency" among advisers and the funds they manage.[3] The Release itself reflects a core assumption that there is an "opacity that is prevalent in the private fund structure" and that the "lack of transparency regarding costs, performance, and preferential terms causes an information imbalance between advisers and private fund investors, which, in many cases, prevents private bilateral negotiations from effectively remedying shortcomings in the private funds market. We [the SEC] believe that this imbalance serves only the adviser's interest and leaves many investors without the tools they need to effectively protect their interests, whether through negotiations or otherwise." Given this ambitious mandate, the proposed rules and related rule amendments, if adopted as proposed, are likely to result in significant burdens on the industry and disrupt the traditional relationship between Private Fund Advisers and private fund investors.

The Release cites Advisers Act Section 211(h) as its authority for certain of the proposed rules. This section, which was adopted as part of the Dodd-Frank Act, generally allows the SEC 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 "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 Commission deems contrary to the public interest and the protection of investors."

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[2] The SEC proposed a one-year compliance period for the rules, to commence 60 days following the publication of final rules in the Federal Register. The Release stated that the SEC's staff is reviewing no-action letters and other interpretive guidance to determine whether any "should be withdrawn or modified in connection with any adoption of this proposal."

[3] SEC Proposes to Enhance Private Fund Investor Protection, SEC Press Release (Feb. 9, 2022).

Coming on the heels of recent speeches by Chair Gensler,[4] proposed amendments to Form PF, which would require certain advisers to provide additional information on the Form PF,[5] and a recent Division of Examinations Risk Alert on the SEC staff's observations from examinations of Private Fund RIAs related to disclosure, diligence on investments and service providers and hedge clauses, the proposed rules represent what is likely to be the most significant and burdensome of the changes to the regime regulating private funds and their advisers since the adoption of the Dodd-Frank Act.[6] As a result, we expect there will be numerous substantive comments on the proposals, and the Release asks many specific questions of advisers to private funds in this connection. Comments are due the later of April 11, 2022, or 30 days from publication in the Federal Register, which is forthcoming as of this date.

This *Newsflash* provides a brief overview of the key elements of the Release.

Quarterly Statements

While advisers are not required to provide quarterly reporting to private fund investors, the Release acknowledges that "most" advisers provide such reports and that "many private fund advisers contractually agree to provide fee, expense and performance reporting to investors." Even so, the SEC has proposed "standardization" of private fund reporting, with Private Fund RIAs being required to prepare and distribute quarterly statements to private fund investors 45 days following a quarter end. Private Fund RIAs would be permitted to use electronic delivery in accordance with the existing SEC guidance on electronic delivery.[7] To promote standardization and comparative review, the proposed rule would require "clear, concise, plain English" disclosure and the information would need to be provided in a table format.[8] Drawing an analogy to the "registered fund context, [where] fund-level reporting has, in our view, enabled retail investors to understand their investments better," the Release states the SEC's view that the proposed quarterly reporting requirements "are necessary to improve the quality of information provided to fund investors" and will assist investors in assessing, monitoring and comparing similar private fund investments.

Under the proposed rule, these statements would need to meet the following specific terms:

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4 SEC Chair Gary Gensler, Prepared Remarks at the Institutional Limited Partners Association Summit, (Nov. 10, 2021). For further information, please refer to *Dechert OnPoint*, SEC Chair Gensler Signals Increased SEC Scrutiny of Private Funds.

5 Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, SEC Proposed Rule, SEC Rel. No. IA-5950 (Jan. 26, 2022) (introducing required current reporting of certain key events for large hedge fund advisers and advisers to private equity funds; expanding reporting for large private equity advisers reduce by lowering the reporting threshold from $2 billion to $1.5 billion, and requiring additional information be reported; and requiring additional reporting regarding fund strategies; and revising reporting requirements for large liquidity fund advisers to be more in line with proposed reporting requirements for money market funds). For further information, please refer to *Dechert NewsFlash*, SEC Proposes Amendments to Form PF.

6 Observations from Examinations of Private Fund Advisers, SEC Division of Examinations Risk Alert (Jan. 27, 2022).

7 The proposed rule would require the quarterly reporting to begin no later than the second full calendar quarter after fund launch.

8 The proposed rule would consolidate reporting for certain fund structures (e.g., parallel funds, master-feeder funds) or to cover substantially similar pools of assets, "to the extent that [consolidated reporting] would provide more meaningful information to the private fund's investors and would not be misleading." The Release explains that "[d]ue to the complexity of private fund structures . . . we believe a principles-based approach to the funds that must provide consolidated reporting is necessary."

- *Fee and Expense Disclosure*. The proposed rule would require the quarterly statement to include standardized information in the form of tables that detail certain fee, expense and performance information (including fees and expenses paid to the adviser (or its related persons) by underlying portfolio investments). The following would apply to fee and expense disclosure:[9]

  - *Private Fund-Level Disclosure Table*. This table would provide detailed information about:

    - *Adviser compensation*. All compensation, fees and other amounts allocated or paid to the adviser (and its related persons) by the private fund during the reporting period with a separate line item (without prescribing categories of fees) for each category that reflects a total dollar amount (e.g., "management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation," as well as fees or expenses related to "consulting, legal, or back-office services" that are provided by the adviser to the fund);

    - *Fund expenses*. All fees and expenses paid by the private fund during the reporting period with a separate line item for each category that reflects a total dollar amount (e.g., "organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses") other than those disclosed as adviser compensation; and

    - *Fee reductions*. Adviser compensation and fund expenses would need to be shown both before and after the application of any offsets, rebates and waivers carried forward during the relevant quarter to subsequent quarterly periods that reduce future payments or allocations to the adviser (or its related persons), presented by category and dollar amount.

  - *Portfolio Investment-Level Disclosure Table*. This table would provide the following information in respect of each "covered portfolio investment":[10]

    - *Portfolio Investment Compensation*. All compensation, fees and other amounts (e.g., "origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments") allocated or paid by the covered portfolio investment during the reporting period to the adviser or the adviser's related persons, to the extent attributable to the private fund's interest in such portfolio investment. The table must include a separate line item for each expense category reflecting the total dollar amount, both before and after the application of any offsets, rebates, or waivers;[11] and

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[9] The Release explains that "principals of the adviser may receive cash or non-cash compensation – such as equity awards or stock options – for serving as directors of a portfolio investment owned by the private fund. Portfolio investment compensation is typically in addition to compensation paid or allocated to the adviser or its related persons at the fund level, unless the fund's governing documents require the adviser to offset portfolio investment compensation against other revenue streams or otherwise provide a rebate to investors."

[10] The term "portfolio investment" includes any entity or issuer in which the private fund has invested directly or indirectly. The term "covered portfolio investment" would include any entity or issuer in which the private fund invested that allocated or paid to the investment adviser or its related persons certain compensation during the reporting period. *See* Proposed Rule 211(h)(1)-1.

[11] The Release explains that the adviser "should disclose the identity of each covered portfolio investment to the extent necessary for an investor to understand the nature of the conflicts associated with such payments."

- *Ownership Percentage*. A list of the quarter-end percentage ownership of the private fund in each covered portfolio investment.[12]

- *Calculations and Cross References to Organizational and Offering Documents*. Each statement would be required "to include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated." This disclosure would describe generally the structure and methodology by which such calculations are made and the criteria (e.g., fixed, asset-based or performance-based) on which each type of compensation is based. Advisers would be required to provide section cross-references to the private fund's offering and governing documents to allow each investor to seek additional information by reviewing those provisions and disclosures.

- *Performance Disclosure*. The proposed rule would require the quarterly statement to include standardized fund performance information, the form and content of which depends on whether the fund is liquid or illiquid.[13] Managers would be required to "display the different categories of required performance information with equal prominence." The performance metrics would need to be consistent with the general framework proposed herein; however, the Release indicates that managers "would remain free to include other performance metrics," so long as the required metrics are presented and the manager otherwise complies with the proposed rule. The following would apply to the performance disclosures:

  - *Performance Reporting Methods*.

    - *Liquid funds*. For liquid funds the adviser would be required to include the following information:

      - Annual net total returns for each calendar year since inception;

      - Average annual net total returns over prescribed time periods (one-, five-, and ten-calendar years); and

      - 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.

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[12] If the fund owns a debt investment or other interest issued by the portfolio company that does not represent a percentage ownership interest, "the adviser would be required to list zero percent as the fund's ownership percentage" and provide a "brief description of the fund's investment."

[13] Prior to preparing the initial quarterly report for a fund, an adviser would be required to determine whether the private fund is liquid or illiquid. According to the Release, a liquid fund generally allows periodic investor redemptions and primarily invests in market-traded securities except for a *de minimis* amount of illiquid assets, while an illiquid fund is generally a closed-end fund that does not offer periodic redemptions (except in exceptional circumstances) and does not invest in publicly-traded securities except for a *de minimis* amount of illiquid assets. The Release defines a "liquid fund" as a private fund that is not an illiquid fund. The Release explains that the definition of "illiquid fund" would align with U.S. GAAP and is proposed to be defined as "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."

- *Illiquid funds*. For illiquid funds, the adviser would be required to include, since inception[14] of the illiquid fund, computed without the impact of any fund-level subscription facilities, the following information:[15]
  - *Fund-level performance*. Gross[16] internal rate of return (IRR)[17] and gross multiple of invested capital (MOIC)[18] and net IRR and net MOIC; and
  - *Realized and unrealized performance*. Gross IRR and gross MOIC for the realized and unrealized portions of the private fund's portfolio, with the realized and unrealized performance shown separately; and
  - *Statement of contributions and distributions.* This should present: "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 the "net asset value of the private fund as of the end of the reporting period covered by the quarterly statement."
  - *Prominent Disclosure of Performance Calculation Information*. The proposed rule would require advisers to disclose the criteria used and assumptions made in calculating performance (e.g., whether dividends reinvested, assumed fee rates) "within the quarterly statement" and not as a separate disclosure.

The Release states that "[i]n circumstances where an investor is itself a pooled vehicle that is controlling, controlled by, or under common control with the adviser or its related persons (a 'control relationship'), the adviser must look through that pool (and any pools in a control relationship with the adviser or its related persons, such as in a master-

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[14] The Release defines "since inception" and quarterly thereafter using quarter-end numbers, but notes that "to the extent quarter-end numbers are not available at the time of distribution of the quarterly statement, an adviser would be required to include performance measures through the most recent practicable date, which we generally believe would be through the end of the quarter immediately preceding the quarter covered by the quarterly statement." The date also should be included.

[15] The Release defines "fund-level subscription facilities" as "any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines, or other indebtedness incurred by the private fund that is secured by the unfunded capital commitments of the private fund's investors." Based on the SEC's view, as reflected in the Release, levered performance numbers for funds employing such facilities "often do not reflect the fund's actual performance," in that such facilities allow the adviser to delay calling capital, potentially increasing performance metrics; the proposed rule would require performance to be calculated "for each illiquid fund as if the private fund called investor capital, rather than drawing down on fund-level subscription facilities."

[16] The Release defines "gross" as performance that does "not reflect the deduction of fees, expenses, and performance-based compensation borne by the private fund."

[17] The Release defines "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. Cash flows would be represented by capital contributions (i.e., cash inflows) and fund distributions (i.e., cash outflows), and the unrealized value of the fund would be represented by a fund distribution (i.e., a cash outflow)."

[18] The Release defines "MOIC" 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. This definition is intended to provide investors with a measure of the fund's aggregate value (i.e., the sum of clauses (i)(A) and (i)(B)) relative to the capital invested (i.e., clause (ii)) as of the end of the applicable reporting period," and to measure "how much" rather than "when" the fund generates a return.

feeder fund structure), in order to send to investors in those pool." This concept of "meaningful delivery" is intended to assure that reporting is made to third parties with an interest in the fund and not just to parties who are affiliated with the adviser.

In addition, the Recordkeeping Rule would be amended to require an adviser to retain: a copy of the quarterly statement; records evidencing the calculation methods; and records substantiating the adviser's determination that the fund is an illiquid or liquid fund.

Private Fund Audits

Currently, most Private Fund RIAs that have custody of private fund assets conduct annual audits of the private fund's financial statements as a part of their compliance with Advisers Act Rule 206(4)-2 (Custody Rule).[19] The proposed amendments would require that all Private Fund RIAs that provide investment advice directly or indirectly to a private fund must cause the fund to undergo an annual audit of the financial statements of their private funds at least annually and upon liquidation and distribute the audited financial statements "promptly" to fund investors. Such an audit would have the following requirements:

- *Requirements for Accountants Performing Private Fund Audit*. The audit would have to be performed by an independent public accountant that meets the standards of independence in Regulation S-X Rule 2-01(b) and (c) that is PCAOB-registered and subject to regular inspection (as of the commencement of the professional engagement period and as of each calendar year-end) in accordance with PCAOB rules.

- *Auditing Standards for Financial Statements*. The audit would have to be consistent with Regulation S-X Rule 1-02(d), and the professional engagement period would have to begin and end as indicated in Regulation S-X Rule 2-01(f)(5).

- *Preparation of Audited Financial Statements*. Audited financial statements would have to be prepared in accordance with U.S. GAAP or, in the case of financial statements of private funds organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States (foreign private funds), would have to contain information substantially similar to statements prepared in accordance with U.S. GAAP, provided that material differences with U.S. GAAP are reconciled.

- *Prompt Distribution of Audited Financial Statements*. Following completion of the audit, the private fund's audited financial statements (which include any reconciliation to U.S. GAAP prepared for a foreign private fund) would have to be distributed promptly. The SEC declined to provide a "specific deadline" or further guidance as to what is or is not "prompt."

- *SEC Notification by Auditor*. Pursuant to a written agreement with the Private Fund RIA or the fund, the auditor would be required to notify the SEC "(i) promptly upon issuing an audit report to the private fund that contains a modified opinion [(i.e, a qualified opinion, an adverse opinion or a disclaimer of opinion)] and (ii) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed." Notifications would be

[19] Other than the Custody Rule requiring specific timing as to distribution of financial statements, the requirements for an audit under the Custody Rule are substantially similar to those proposed here.

through electronic means as directed by the Division of Examinations and would be required to include the auditor's "contact information and indicate its reason for sending the notification."[20]

- *Independent Subadvisers*. If a Private Fund RIA does not control, is not controlled by and is not under common control with a private fund, then the adviser would have to "take all reasonable steps" to cause the fund to undergo an audit that meets the requirements of the rule, which is a facts-and-circumstances determination.

The Release explains that the audit is intended to protect investors from misappropriation, and that the SEC "believe[s] an audit by an independent public accountant would provide an important check on the adviser's valuation of private fund assets, which often serve[s] as the basis for the calculation of the adviser's fees." Additionally, while the proposed rule is "based on the custody rule and contains many similar or identical requirements," there are some notable differences: (1) the proposed rule does not provide an alternate means of compliance; (2) the proposed rule has different written agreement and notification provisions; (3) the proposed rule's only exception is for an adviser that is not in a control relationship with the private fund but "takes all reasonable steps" to cause the fund to meet the proposed rule requirements; and (5) delivery under the proposed rule would be required to be "prompt" while the Custody Rule imposes specific deadlines. As a result, the Release informs advisers that "compliance with either rule would not automatically satisfy the requirements of the other."

The proposal would also amend the Recordkeeping Rule to require a Private Fund RIA to: retain a copy of the audited financial statements; keep a delivery record (i.e., recipient, address, date sent, delivery method); and document the steps it has taken to cause the private fund client (not in a control relationship) to undergo a financial statement audit that complies with the proposed rule.

Adviser-Led Secondaries

Currently, there are no specific requirements for, nor any prohibition or limitation on, adviser-led secondaries, so long as the adviser meets general Advisers Act requirements related to cross trades and complies with the Advisers Act's antifraud provisions. The proposed rule would prohibit the completion of "adviser-led secondary transactions" with respect to any private fund, "unless the adviser distributes to investors in the private fund, prior to the closing of the transaction, a fairness opinion from an independent opinion provider and a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider." Under the proposed rule, an "adviser-led secondary transaction" would include offers by a Private Fund RIA to an investor in any private fund to sell all or any portion of an investor's interest in the fund, or to convert or exchange some or all of an investor's interest in the fund for an interest in another vehicle advised by the Private Fund RIA or its related persons. The proposed rule would prohibit adviser-led secondary transactions unless the following requirements are met:

- *Fairness Opinion from an Independent Opinion Provider*. The Private Fund RIA would have to obtain a fairness opinion from an "independent opinion provider" stating that the price offered to the fund for assets being sold as part of the transaction is fair, and distribute the opinion to investors in the private fund prior to the close of the transaction. Under the proposed rule, an independent opinion provider would include an

[20] An adviser reports in Form ADV, Part 1A, Section 7.B.1 the identity of the private fund auditor and whether the adviser received a qualified audit opinion with respect to the private fund.

entity that "(i) provides fairness opinions in the ordinary course of its business and (ii) is not a related person of the adviser."

- *Material Business Relationship Summary*. The Private Fund RIA would have to prepare and distribute to private fund investors a summary of any material business relationships the Private Fund RIA (or any of its related persons) has, or has had within the past two years, with the independent opinion provider. The Release indicates that the determination of whether a business relationship is material will be based on the facts-and-circumstances, and suggests that "audit, consulting, capital raising, investment banking and other similar services" from a provider to the Private Fund RIA (or its related persons) "typically" would be material under the proposed rule.

The Release provides examples of such transactions, including: single asset transactions; strip sale transactions; full fund restructurings; and tender offers to new investors. The Release notes that whether an offer is "initiated" by the adviser would be a facts-and-circumstances determination, and that the SEC generally would view circumstances where the adviser commences (or causes another person to commence a process designed to be) an adviser-led secondary transaction; however, the SEC would not view a transaction resulting from an unsolicited request from an investor as being initiated by the Private Fund RIA. In addition, the Release states that the proposed rule would apply to certain situations where investors are being offered an opportunity to sell, convert or exchange their private fund interest in connection with: the sale of all or a portion thereof to another vehicle managed by the Private Fund RIA (i.e., a cross sale); or a fund restructuring.

The Release explains that while adviser-led secondaries provide liquidity to investors, Private Fund RIAs can be on both sides of a transaction and potentially receive benefits (e.g., additional fees) from their completion as a result. The SEC indicated that this provision would ensure that investors receive an "independent price assessment" and are "offered a fair price," thereby increasing the investors' decision-making ability and confidence in the transaction. The Release states that this would provide an "important check against the adviser's conflicts of interest in structuring and leading a transaction" in the secondary market, where Private Fund RIAs are "increasingly active."

The proposal would amend the Recordkeeping Rule to require Private Fund RIAs to retain a copy of the fairness opinion and material business relationship summary, as well as a record of delivery (i.e., recipient, address, date sent, delivery method).

Certain Other Prohibited Activities

Currently, the regime governing private funds largely does not prohibit most activities that can be fully and fairly disclosed to, and thus consented to, by investors. Signaling a significant shift in regulatory approach, the proposed rule includes specific prohibitions on certain practices by Private Fund Advisers (again, regardless of registration status) and their related persons, that the SEC deems to be contrary to the public interest and the protection of investors (e.g., certain sales practices, conflicts of interest and compensation schemes). These prohibitions would apply even if such activities are permitted by the governing documents of the private fund or otherwise fully disclosed to investors and even if the fund's investors or an advisory board comprised of fund investors (e.g., an LPAC) has consented thereto. Specifically, the proposed rule would prohibit Private Fund Advisers from engaging directly or indirectly (i.e., through its related persons) in the following activities with respect to a private fund or private fund investor:

- *Fees for Unperformed Services*. Charging "monitoring, servicing, consulting, or other fees" to a portfolio investment for any "services the investment adviser does not, or does not reasonably expect, to provide" (which the SEC referred to as "accelerated payments"). The Release notes, however, that this prohibition would not apply if an adviser charges fees to a portfolio investment for services that actually are performed or to advance payments for services the adviser reasonably expects to provide, in each case so long as advisers would be required under the proposed rule to refund any prepaid fees for services that ultimately are not performed. In addition, the Release states that the proposed rule is not intended to prohibit an adviser from offsetting its management fees with fees charged to portfolio investments. However, the Release cautions that any fees charged to a portfolio investment in excess of 100% of the management fees could be subject to the prohibition.

- *Certain Fees and Expenses*. Charging a private fund for any "regulatory or compliance expenses or fees of the adviser" (or its related persons) or any fees and expenses "associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities." The Release notes, however, that charging a private fund for regulatory, compliance or similar fees and expenses that are directly related to the activities of the private fund (e.g., filing a Form D) would not be prohibited under this proposed rule. The Release explains that if it is not clear whether a fee or expense relates to the adviser or fund, "an adviser generally should allocate such fees and expenses in a manner that it believes in good faith is fair and equitable and is consistent with its fiduciary duty."

- *Reducing Adviser Clawbacks for Taxes*. Reducing the amount of an adviser's "clawback" (i.e., any obligation requiring the adviser to return some or all of the performance-based compensation[21] to the fund under the fund's governing documents) by "actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders." Importantly, the Release notes that this proposed prohibition would apply broadly to an adviser's owners and interest holders (even if otherwise unaffiliated with the adviser), to the extent that such unaffiliated persons are allocated a portion of the adviser's performance-based compensation.

- *Limiting or Eliminating Liability for Adviser Misconduct*. "Seeking reimbursement, indemnification, exculpation, or limitation of" an adviser's liability "for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund." Continuing to develop themes regarding "hedge clauses" from the IA Standard of Conduct Interpretation, the SEC is seeking to restrict the scope and effect of contractual provisions that limit a Private Fund Adviser's liability for conduct that the SEC believes is inconsistent with its views of the fiduciary obligations imposed by the Advisers Act.[22] The SEC stated that it believes that in "limiting an adviser's responsibility for breaching the standard of conduct, the incentive to comply with the required standard of conduct is eroded."[23]

- *Certain Non-Pro Rata Fee and Expense Allocations*. Charging or allocating fees and expenses related to a portfolio investment or a potential portfolio investment, "on a non-pro rata basis when multiple private funds

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21 The Release defines "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."

22 Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Interpretation (June 5, 2019) (IA Standard of Conduct Interpretation). For further information, please refer to *Dechert NewsFlash* SEC Adopts Enhanced Standard of Conduct for Broker-Dealers and Clarifies Fiduciary Duties of Investment Advisers.

23 Observations from Examinations of Private Fund Advisers, SEC Division of Examinations Risk Alert (Jan. 27, 2022).

and other clients advised by the adviser" (or its related persons) have invested in, or propose to invest in, the same portfolio investment. There are no exceptions to this prohibition. The Release explains that this prohibition would apply to prospective investments that are not consummated (e.g., "broken-deal" expenses would have to be allocated *pro rata* among all funds that proposed to invest). However, the Release indicates the proposed rule would not prohibit an adviser from using its own capital to pay a client's *pro rata* share of such fees and expenses, nor would it prohibit a fund that does not have sufficient resources to pay its share of fees and expenses from diluting its interest in the investment in a manner that is "economically equal to its *pro rata* portion of such fee or expense."

- *Borrowing*. "Borrowing money, securities, or other [private] fund assets, or receiving" a loan or "an extension of credit, from a private fund client" (collectively, borrowing). The Release states that the proposed rule would not prohibit an adviser from borrowing on behalf of the fund under a subscription line of credit provided by a third party or lending money directly to the fund.

The Release states these activities should be prohibited as they "incentivize" Private Fund Advisers to put their own interests first, particularly to the determinant of smaller investors, who are unable to negotiate preferential terms and could bear "an unfair proportion of fees and expenses." The Release further states the SEC's view that these "prohibitions are necessary given the lack of governance mechanisms that would help check overreaching by private fund advisers."

Preferential Treatment and Restrictions on Side Letters

Currently, the use of side letter agreements to grant favorable terms to select investors is common and not subject to any specific requirements or limitations; however, the Advisers Act antifraud provisions would require that any material arrangements and related conflicts be fully and fairly disclosed. The proposed rule would prohibit all Private Fund Advisers (again, regardless of registration status) from providing preferential redemption rights or providing preferential information, that "the adviser reasonably expects to have a material, negative effect" on investors in that fund or a substantially similar pool of assets.[24] Additionally, the proposed rule would require certain disclosures if the Private Fund Adviser otherwise grants "preferential terms" to investors in a private fund or investors in a "substantially similar pool of assets." The proposed rule would restrict the ability of Private Fund Advisers and investors to negotiate terms as follows:

- *Prohibited Preferential Redemptions*. A Private Fund Adviser would be prohibited from providing preferential redemption rights to a private fund investor, if "the adviser reasonably expects" that doing so would have a "material, negative effect" on other investors in the fund or a substantially similar pool. The Release notes that preferential redemption rights in a fund (or a feeder) could have a negative effect on other investors if the fund sells liquid assets to pay for the redemption and leaves the fund with a portfolio of less liquid assets, which could in turn result in (among other negative effects) the inability of the fund to: continue its

[24] The Release includes a definition of "substantially similar pool of assets," defined as a "pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser or its related persons." Such pools could include funds or CLOs relying on other exceptions such as Sections 3(c)(3), 3(c)(5) and 3(c)(11) of, or 3a-7, under the Investment Company Act. Whether the fund and another pool have substantially similar investment policies, objectives and restrictions would require a facts-and-circumstances analysis.

investment strategy; and satisfy subsequent redemption requests. This could dilute the interests of remaining investors.

- *Prohibited Preferential Transparency*. A Private Fund Adviser would be prohibited from providing information to a private fund investor regarding the private fund's (or substantially similar pool of assets) portfolio holdings and exposures, if the adviser "reasonably expect[ed]" that doing so would have a "material, negative effect" on other investors in the fund or a substantially similar pool of assets. The Release suggests that preferential rights to information could have a negative effect on investors by enabling front running or loss-avoidance behavior by the preferred investor to the detriment of other fund investors.

- *Other Preferential Treatment*. A Private Fund Adviser would be prohibited from agreeing to any other preferential treatment with a private fund investor, unless the Private Fund Adviser discloses specific information about the preferential treatment in writing to prospective investors prior to their investment in the applicable fund, and to existing investors annually if preferred terms have been granted to such investors since the last written notice provided. Further, Private Fund Advisers "would need to describe specifically the preferential treatment to convey its relevance," and the Release suggests Private Fund Advisers could provide: a written summary of the preferential terms (e.g., description of lower fee arrangements and/or the range of lower fees) received in the same fund or copies of redacted side letters to other investors. Additionally, "if an investor is a pooled investment vehicle that is in a control relationship with the adviser, the adviser must look through that pool in order to send the notice to investors in those pools."

The Release indicates that whether a particular right is "preferential" and whether a preferential term or information provided on a selective basis would be reasonably expected by the adviser to have a material, negative effect would require consideration of relevant facts and circumstances.

As proposed, the Recordkeeping Rule would be amended to require advisers to retain copies of: all written notices sent to prospective and existing investors; and a record of delivery (e.g., recipient, address, dates sent, delivery method).

RIA Annual Compliance Reports

Currently, Advisers Act Rule 206(4)-7 (Compliance Rule) requires RIAs to review the adequacy of their compliance policies and procedures and the effectiveness of their implementation at least annually but does not expressly require written documentation of such review.[25] The proposed amendments to the Compliance Rule would require that every RIA document its annual review in writing (an annual compliance report) and provide such annual compliance reports promptly to the SEC upon request. The Release explains that if an RIA conducts and documents reviews of its compliance policies and procedures or a subset thereof more frequently (e.g., quarterly), those reports, taken together, would constitute an annual compliance report that satisfies the requirements of the proposed rule. The Release also states that the SEC has "observed claims of the attorney-client privilege, the work-product doctrine, or other similar protections over required records" because such documents were prepared by "attorneys working for the adviser in-house or the engagement of law firms and other service providers (e.g., compliance consultants) through

[25] See Compliance Programs of Investment Companies and Investment Advisers, SEC Final Rule, SEC. Rel. Nos. IA-2204 and IC-26299 (Dec. 17, 2003).

law firms," and conveys the SEC's sense that attempts to shield or delay production undermine the SEC staff's ability to conduct examinations.

Potential Implications

If adopted, the proposals in the Release would be the most sweeping change to the private fund regulatory regime since the SEC implemented the registration of most Private Fund Advisers under the Dodd-Frank Act and related rules, and would reflect a major change in the SEC's approach to the regulation of private funds specifically and the Advisers Act more generally, including by introducing absolute prohibitions on particular activities. Notably, the proposal would impose substantive regulation for the first time on a set of industries that currently operate under what is largely a disclosure-based regime that has enabled market forces and negotiations to protect investors. Instead, the proposal would introduce substantive restrictions without meaningful exceptions, which would reduce the ability of sophisticated private parties to negotiate the terms of their investments in private funds with Private Fund Advisers on their own terms and in their own interests, including with respect to such critical matters as the amount of risk that each party is willing to bear. This shift in regulatory policy would, no doubt, have impacts beyond the specific proposed restrictions and, if implemented, the proposed rule would likely require major, industry-wide efforts to revise and renegotiate the terms of fund disclosure and organizational documents, which could have an adverse impact on fees and availability of private funds generally, with the potential for significant and disparate impacts on a number of types of investment strategies.

Next Steps

The Release sets forth a number of requests for comment regarding each of the proposed new rules and amended rules. Industry participants should carefully consider the implications of the proposal and may want to consider submitting comments to the SEC on the proposed changes. The Release also proposes a one-year transition period for compliance with the new and amended rules. Further, the Release states that the SEC staff is reviewing no-action letters and interpretive guidance to determine if any withdrawals or modifications are appropriate in connection with the proposed rules and rule amendments.

The public comment period will remain open until the later of: April 11, 2022; or 30 days following publication in the Federal Register, which is forthcoming as of this date.

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