To Our Clients and Friends

Memorandum

February 10, 2022

SEC Proposes Sweeping New Rules and Amendments to Existing Rules Applicable to Private Fund Advisers

On February 9, 2022, the Securities and Exchange Commission ("SEC") voted 3-1 in favor of proposed new rules and rule amendments (the "Proposal") under the Investment Advisers Act of 1940 (the "Advisers Act") applicable to private fund advisers.[1] The new rules (the "Proposed Rules"), if adopted as proposed, would result in material changes to various longstanding business and legal practices in the private fund industry, and we expect significant comments and input from industry participants on certain aspects of the Proposal. The Proposed Rules do not include a grandfathering provision, and therefore existing private funds would need to modify their established terms and practices.

The Proposed Rules would (1) prohibit all private fund advisers (whether registered or unregistered) from engaging in certain activities and practices regardless of consent from the private fund investors or applicable advisory committees, (2) prohibit all private fund advisers (whether registered or unregistered) from granting certain side letter terms and requiring them to disclose to existing and prospective investors certain other preferential terms granted to other investors in private funds, (3) require registered private fund advisers to provide investors with detailed quarterly statements disclosing information about private fund performance, fees, and expenses, (4) require registered private fund advisers to send audited financial statements to all private fund investors, and (5) require registered private fund advisers to obtain an independent fairness opinion in connection with adviser-led secondary transactions. The Proposal also includes proposed amendments (the "Proposed Amendments") to (1) Advisers Act rule 206(4)-7 that would require all registered advisers to document their annual compliance reviews in writing and (2) Advisers Act rule 204-2 that would create new recordkeeping requirements for registered private fund advisers related to the Proposed Rules. Each Proposed Rule is summarized in turn below.

PROPOSED RULES

1. Prohibited Activities. Proposed Rule 211(h)(2)-1 (the "Prohibited Activities Rule") would prohibit private fund advisers (both registered and unregistered) from engaging in the following practices with respect to the private funds they manage, even where such practices are disclosed and consented to:

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release No. IA-5955 (Feb. 9, 2022) ("Proposing Release"). A "private fund adviser" means an adviser to an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 ("Investment Company Act"), but for section 3(c)(1) or 3(c)(7) of that Act.

(a) *Limiting or eliminating liability for adviser misconduct*. The Prohibited Activities Rule would prohibit a private fund adviser 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 in providing services to the private fund.[2] This would, among other things, not allow an adviser to be exculpated for ordinary negligence.

(b) *Fees for unperformed services*. The Prohibited Activities Rule would prohibit a private fund adviser from charging a portfolio investment[3] 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.[4] For example, the Prohibited Activities Rule would prohibit acceleration clauses in management services agreements between an adviser and a portfolio investment that permit the adviser to accelerate the unpaid portion of the fee upon an initial public offering or other triggering event even though the adviser will never provide the services.[5]

(c) *Fees relating to government and regulatory examinations and regulatory and compliance fees*. The Prohibited Activities Rule would prohibit a private fund adviser from charging a private fund for (i) fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority[6] and (ii) any regulatory or compliance fees or expenses incurred by the adviser or its related persons.[7] The Proposing Release states, for example, that advisers should bear the compliance expenses related to their registration with the SEC, including fees and expenses related to preparing and filing Form ADV.[8] Conversely, the Proposing Release states that the Prohibited Activities Rule would not prohibit an adviser from charging a private fund for the costs associated with a fund's regulatory filing, such as Form D.[9] The Proposing Release states that this aspect of the Prohibited Activities Rule would likely require advisers that utilize a pass-through expense model (i.e., where the private fund pays for most, if not all, expenses, including the adviser's expenses, but the adviser does not charge a management, advisory, or similar fee) to re-structure their fee and expense model.[10]

(d) *Clawback reductions for taxes*. The Prohibited Activities Rule would prohibit a private fund adviser from reducing the amount of any clawback of performance-based compensation by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.[11]

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2 Proposed Rule 211(h)(2)-1(a)(5).

3 The SEC proposes to define a "portfolio investment" to mean any entity or issuer in which the private fund has directly or indirectly invested. Proposed Rule 211(h)(1)-1.

4 Proposed Rule 211(h)(2)-1(a)(1).

5 Proposing Release at 136.

6 Proposed Rule 211(h)(2)-1(a)(2).

7 Proposed Rule 211(h)(2)-1(a)(3).

8 Proposing Release at 141.

9 Id. at 142.

10 Id. at 141.

11 Proposed Rule 211(h)(2)-1(a)(4).

(e) *Non-pro rata fee and expense allocations*. The Prohibited Activities Rule would prohibit a private fund adviser from charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment.[12] The Proposing Release states that many advisers do not charge co-investment vehicles or other co-investors for fees and expenses relating to unconsummated investments, and that such fees and expenses are instead borne by the main fund participating in the transaction. This practice would be prohibited under the Prohibited Activities Rule, although the Proposing Release states that the Prohibited Activities Rule would not prohibit a private fund adviser from allocating to the main fund the broken-deal expenses attributable to a potential co-investor that has not executed a binding agreement to participate in the transaction through a co-investment vehicle (or other fund) managed by the adviser.[13]

(f) *Borrowing from private fund clients.* The Prohibited Activities Rule would prohibit a private fund adviser directly or indirectly from borrowing money, securities, or other private fund assets, or receiving a loan or an extension of credit, from a private fund client.[14] The Prohibited Activities Rule would not prevent an adviser from borrowing from a third party on behalf of a private fund or from lending to a fund.[15]

2. Preferential Treatment. Proposed Rule 211(h)(2)-3 (the "Preferential Treatment Rule") would prohibit private fund advisers (both registered and unregistered) from affording the following types of preferential treatment to private fund investors:

(a) *Preferential Redemptions.* The Preferential Treatment Rule would prohibit a private fund adviser from granting an investor in a private fund or in a substantially similar pool of assets[16] 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.[17] The Proposing Release states that preferential liquidity can harm a private fund and other investors if, for example, an adviser allows a preferred investor to exit the fund early and sells liquid assets to accommodate the preferred investor's redemption, leaving the fund with a less liquid pool of assets, which can inhibit the fund's ability to carry out its investment strategy or promptly satisfy other investors' redemption requests.[18]

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12 Proposed Rule 211(h)(2)-1(a)(6).

13 Proposing Release at 154-55 and n. 180.

14 Proposed Rule 211(h)(2)-1(a)(7).

15 Proposing Release at 159.

16 The SEC proposes to define a "substantially similar pool of assets" to mean a pooled investment vehicle (other than an investment company registered under the Investment Company Act 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 investment adviser or its related persons. Proposed Rule 211(h)(1)-1.

17 Proposed Rule 211(h)(2)-3(a)(1).

18 Proposing Release at 165.

(b) *Preferential Transparency*. The Preferential Treatment Rule would prohibit a private fund adviser from providing information regarding the portfolio holdings or exposures of a 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 investors in that private fund or in a substantially similar pool of assets.[19] The Proposing Release states that preferential transparency can result in profits or avoidance of losses among those who were privy to the information beforehand at the expense of investors who did not benefit from such transparency, and could enable investors to trade in portfolio holdings in a way that "front-runs" or otherwise disadvantages a private fund or other clients of the adviser.[20]

The Preferential Treatment Rule would also prohibit private fund advisers from providing any other type of preferential treatment to any private fund investor unless the adviser provides other investors and potential investors in the same private fund with a written notice that provides specific information regarding the preferential treatment.[21] For example, the Proposing Release states that if an adviser provides a private fund investor with lower fee terms in exchange for a significantly higher capital contribution than paid by other investors, the adviser must describe the lower fee terms, including the applicable rate (or range of rates) paid; mere disclosure that some investors pay a lower fee would not be specific enough to satisfy the requirements of the Proposed Rule.[22] The Preferential Treatment Rule provides that with respect to prospective investors in a private fund, the adviser must provide the written notice prior to the prospective investor's investment in the private fund,[23] and that with respect to current investors in a private fund, the adviser must provide the written notice on at least an annual basis.[24]

3. <u>Quarterly Statements</u>. Proposed Rule 211(h)(1)-2 (the "Quarterly Statements Rule") would require registered private fund advisers to provide quarterly statements to investors in private funds that have at least two full calendar quarters of operating results within 45 days after the end of each calendar quarter. The Quarterly Statements Rule would require advisers to include the following information in each quarterly statement:

- *Fund Table*. A table ("Fund Table") that discloses, at a minimum:

  (i) all compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons 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, presented both before and after the application of any offsets, rebates, or waivers;

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19 Proposed Rule 211(h)(2)-3(a)(2).

20 Proposing Release at 166.

21 Proposed Rule 211(h)(2)-3(b).

22 Proposing Release at 169-70.

23 Proposed Rule 211(h)(2)-3(b)(1).

24 Proposed Rule 211(h)(2)-3(b)(2).

(ii) all fees and expenses paid by the private fund during the reporting period (other than those listed in (i) 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, presented both before and after the application of any offsets, rebates, or waivers; and

(iii) 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.[25]

- *Portfolio Investment Table*. A separate table ("Portfolio Investment Table") that discloses, for each of the fund's covered portfolio investments[26], at a minimum:

  (i) 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

  (ii) 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.[27]

- *Disclosure Regarding Calculation Methodology*. Prominent disclosure regarding the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated. The quarterly statements must also include cross references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.[28]

- *Performance Information.* Certain performance information with respect to the private fund, which differs depending on whether the private fund is classified as an illiquid fund or a liquid fund.[29]

  (i) Illiquid Funds.[30] The Quarterly Statements Rule would require the quarterly statements for illiquid funds to include the following with equal prominence:

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25 Proposed Rule 211(h)(1)-2(b).

26 The SEC proposes to define a "covered portfolio investment" to mean a portfolio investment that allocated or paid the investment adviser or its related persons "portfolio investment compensation" during the reporting period. Proposed Rule 211(h)(1)-1. The SEC proposes to define "portfolio investment compensation" to mean any compensation, fees, and 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. Id.

27 Proposed Rule 211(h)(1)-2(c).

28 Proposed Rule 211(h)(1)-2(d).

29 Proposed Rule 211(h)(1)-2(e).

30 The SEC proposes to define "illiquid fund" to mean 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

- gross internal rate of return ("IRR")[31] and gross multiple of invested capital ("MOIC")[32];
- net IRR[33] and net MOIC[34];
- gross IRR and gross MOIC for the realized and unrealized portions of the fund's portfolio, with the realized and unrealized performance shown separately; and
- a statement of contributions and distributions.

These performance measures must be shown since inception of the 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.[35]

(ii) Liquid Funds.[36] The Quarterly Statements Rule would require the quarterly statements for liquid funds to include the following with equal prominence:

- annual net total returns for each calendar year since inception,
- average annual net total returns over the one-, five-, and ten- calendar year periods; 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.[37]

The Quarterly Statements Rule provides that the quarterly statement must use clear, concise, plain English and be presented in a format that facilitates review from one quarterly statement to the next.[38] The rule also provides that the adviser must consolidate the quarterly statement to cover substantially similar pools of assets if doing so would provide more meaningful information to the private fund's investors and would not be misleading.[39] For example, with respect to a master-feeder structure, the Quarterly Statements Rule would require the adviser to provide feeder fund investors with a single quarterly statement covering the applicable feeder fund and the feeder fund's proportionate interest in the

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acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments. Proposed Rule 211(h)-1.

31 The SEC proposes to define "gross IRR" to mean an internal rate of return that is calculated gross of all fees, expenses, and performance-based compensation borne by the private fund. Proposed Rule 211(h)-1.

32 The SEC proposes to define "gross MOIC" to mean multiple of invested capital that is calculated gross of all fees, expenses, and performance-based compensation borne by the private fund. Proposed Rule 211(h)-1.

33 The SEC proposes to define "net IRR" to mean an internal rate of return that is calculated net of all fees, expenses, and performance-based compensation borne by the private fund. Proposed Rule 211(h)-1.

34 The SEC proposes to define "net MOIC" to mean a multiple of invested capital that is calculated net of all fees, expenses, and performance-based compensation borne by the private fund. Proposed Rule 211(h)-1.

35 Proposed Rule 211(h)(1)-2(e)(2)(b).

36 The SEC proposes to define "liquid fund" to mean a private fund that is not an illiquid fund. Proposed Rule 211(h)-1.

37 Proposed Rule 211(h)(1)-2(e)(2)(a).

38 Proposed Rule 211(h)(1)-2(g).

39 Proposed Rule 211(h)(1)-2(f).

master fund on a consolidated basis (as long as the consolidated statement would provide more meaningful information to investors and would not be misleading).[40]

4. **Mandatory Private Fund Audits**. Proposed Rule 206(4)-10 (the "Audit Rule") would require a registered private fund adviser to obtain, with respect to each private fund that it advises, a financial statement audit performed by an independent public accountant at least annually, and upon liquidation. The Audit Rule would generally require the audited financial statements to be prepared in accordance with U.S. Generally Accepted Accounting Principles ("U.S. GAAP"). In the case 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, the Audit Rule would require the audited financial statements to contain information substantially similar to statements prepared in accordance with U.S. GAAP and all material differences with U.S. GAAP to be reconciled.[41] The Audit Rule would require private fund advisers to distribute the audited financial statements promptly after completion of the audit.[42] The Audit Rule would also require a written agreement between the private fund adviser and the auditor pursuant to which the auditor would be required to notify the SEC's Division of Examinations upon the auditor's termination or issuance of a modified opinion.[43] In the case of a private fund that the adviser does not control, and is neither controlled by nor under common control with the adviser (e.g., a third-party fund sub-advised by the private fund adviser), the Audit Rule would require the adviser (i.e., the third-party sub-adviser in the example) to take all reasonable steps to cause the private fund to undergo a financial statement audit that meets the requirements of the Audit Rule.[44]

5. **Adviser-Led Secondaries.** Proposed Rule 211(h)(2)-2 (the "Secondaries Rule") would prohibit registered private fund advisers from closing an adviser-led secondary transaction[45] with respect to any private fund unless the adviser obtains and distributes to the private fund investors a fairness opinion from an independent opinion provider. The Secondaries Rule would also require the adviser to prepare and distribute to the private fund investors 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. The Proposing Release states that whether a secondary transaction is initiated by the adviser or its related person requires a facts and circumstances analysis, and that it would generally not view a transaction as initiated by the adviser if the adviser, at the unsolicited request of an investor, assists in the secondary sale of such investor's fund interest.[46]

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40 Proposing Release at 92.

41 Proposed Rule 206(4)-10(c).

42 Proposed Rule 206(4)-10(d).

43 Proposed Rule 206(4)-10(e).

44 Proposed Rule 206(4)-10(f).

45 The SEC proposes to define "adviser-led secondary transaction" to mean any transaction initiated by the investment adviser or any of its related persons that offers private fund 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. Proposed Rule 211(h)-1.

46 Proposing Release at 123.

COMMENT PERIOD, TRANSITION PERIOD AND COMPLIANCE DATE

The SEC requests comments on all aspects of the Proposal, which will be due on the later of (a) 30 days after the Proposing Release is published in the Federal Register or (b) April 11, 2022. The Proposing Release includes extensive questions regarding:

- whether there are certain activities that the Proposal addresses in the private fund context that should also be addressed in other contexts, such as with respect to separately managed accounts or pooled investment vehicles that rely on the exclusion from the definition of "investment company" in section 3(c)(5)(C) of the Investment Company Act;
- whether certain of the prohibited practices should be permitted if they are fully disclosed and consented to;
- whether the Proposed Rules should apply to certain or all advisers (e.g., registered advisers, exempt reporting advisers, sub-advisers, and non-U.S. advisers);
- how the Proposed Rules would affect operating expenses of advisers, management fees for investors, and the ability to attract co-investors and investment professionals;
- whether certain fees should be subject to caps and whether certain compensation or expense arrangements should be prohibited;
- how the Proposed Rules would impact private fund advisers that rely on certain exceptions or approaches in Advisers Act rule 206(4)-2, the custody rule, and do not obtain annual audits for their funds; and
- whether certain exceptions would be appropriate for certain aspects of the Proposed Rules (e.g., private funds below a certain asset threshold excepted from the audit requirement, quantitative or algorithmic funds excepted from providing investment-level disclosure, or first-time fund advisers or advisers using pass-through expense models excepted from prohibition on charging compliance and regulatory expenses to the fund).

The SEC proposes a one-year transition period to provide time for advisers to come into compliance with the Proposed Rules and Amended Rules, if they are adopted. Accordingly, the proposed compliance date of any adoption of the Proposal would be one year following the rules' effective dates, which would be sixty days after the date of publication of the adopted rules in the Federal Register.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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