

SEC PROPOSES SIGNIFICANT NEW RULES FOR PRIVATE FUND ADVISERS

Date: 7 April 2022

U.S. Asset Management and Investment Funds Alert

By: Ed Dartley, Kenneth Holston, Ruth E. Delaney, Kasey L. Lekander, Yasho Lahiri

The Securities and Exchange Commission (the SEC) on 9 February 2022 proposed new rules and amendments (collectively, the Proposed Rules) under the Investment Advisers Act of 1940, as amended (the Advisers Act).¹ Importantly, certain of the Proposed Rules would greatly expand regulatory compliance obligations for all investment advisers to private funds, including exempt reporting advisers, foreign private advisers and other investment advisers to private funds that are not otherwise required to register with the SEC (for example, state registrants) (collectively, private fund advisers).

The SEC generally designed the Proposed Rules to: (i) provide private fund investors with increased transparency, and (ii) prohibit private fund advisers from engaging in certain practices that the SEC has identified as particularly susceptible to conflicts of interest and areas of enhanced investor risk. The Proposed Rules are subject to public review and comment until 25 April 2022. The SEC has proposed a transition period of one year following the issuance of final rules to provide private fund advisers with time to come into compliance with the Proposed Rules.

While the Proposed Rules are still in the comment period, private fund advisers and investors alike should familiarize themselves now with the many changes that the Proposed Rules would impose. To date there have been approximately 80 comment letters submitted to the SEC.² Although industry groups and others likely will continue to submit comments, absent significant industry input, we expect that the Proposed Rules will substantially impact the ability of sophisticated private fund investors to negotiate terms in connection with their investments in private funds and, potentially, increase fees and expenses for private fund investors to ensure compliance with the Proposed Rules. In particular, because there is no grandfathering provision contemplated in the Proposed Rules, private fund advisers would be required to review, and likely amend, existing fund documents to bring them into compliance with the Proposed Rules.

PROHIBITED ACTIVITIES

The Proposed Rules would prohibit the following activities for private fund advisers, regardless of registration status. Designed to prevent perceived conflicts of interests identified by the SEC, the prohibitions represent a material departure from the SEC's historical approach to conflicts of interest.³ Specifically, the Proposed Rules would eliminate the ability of private fund advisers to satisfy their duty of loyalty by fully and fairly disclosing a conflict of interest and obtaining informed consent to such conflict. Instead, the Proposed Rules would effectively prohibit certain conflicts entirely when they arise in the context of private funds, regardless of the sophistication of the parties involved or the steps taken to ensure investors understand the proposed arrangements.

Preferential Treatment

In perhaps the biggest departure from current practices, the Proposed Rules would strictly prohibit certain types of side agreements between private fund advisers and investors in a private fund related to:

- Granting preferential liquidity terms.
- Providing information regarding portfolio holdings or exposures of the private fund to any investor, in each case, if the private fund adviser reasonably expects that such preferential treatment would have a material, negative effect on other investors in the fund.

In addition, the Proposed Rules would prohibit private fund advisers from entering into an agreement with an investor to provide any other kind of preferential treatment without also providing:

- Written notice to each prospective investor that includes specific disclosure regarding any preferential treatment.
- Annual written notice to current investors in an ongoing offering that includes specific disclosure regarding any preferential treatment provided by the private fund adviser to other investors in the private fund. Private fund advisers may comply with the proposed disclosure requirements by providing copies of side letters (with investors' identifying information redacted) or by providing a sufficiently detailed written summary of preferential terms provided.

Considerations for Private Fund Advisers

- ***Side letters:*** This aspect of the Proposed Rules represents a significant departure from the current practice of many private fund advisers and institutional and other investors with respect to side letters and other similar written agreements. Rather than a privately negotiated side letter process, private fund advisers would be required to provide all investors and prospective investors with specific information regarding preferential terms of side letters, adding a new dynamic to the already complex negotiation of key terms. By the same token, institutional investors that have a developed negotiating strategy and a set of side letter terms would need to accept that such terms would be specifically disclosed to other investors.
- ***"Preferential treatment":*** The SEC has not provided guidance as to what constitutes "preferential treatment" or "specific" information of such preferential treatment, leaving private fund advisers to determine the level of information to be included in notices to prospective and current investors. This lack of clarity may lead to challenging judgment calls when assessing whether, for instance, noneconomic side letter terms constitute preferential treatment.
- ***Seeding arrangements:*** Many smaller and emerging managers forge relationships with one or a handful of "seed" or "anchor" investors, who provide outsized capital commitments and contributions of time and expertise to help a manager establish itself in the market. In return, such seed investors are typically given favorable terms with respect to fund-level investments. While the Proposed Rules would require disclosure of such terms, the distinctive active role that seed investors play would distinguish their arrangements from those of other investors making a "passive" fund investment. Nevertheless, private fund advisers and seed investors will need to consider the extent and the impact of disclosures provided to prospective investors regarding these arrangements and whether information rights afforded to seed investors.

- *Allowances for regulatory requirements:* Notably absent from the Proposed Rules is an exception allowing for common liquidity terms and restrictions on receipt of confidential information that are related to the regulatory status of certain types of investors, such as the Employee Retirement Income Security Act of 1974 and governmental plans. Inflexibility in this area may have the effect of limiting the universe of investment opportunities for certain classes of investors.

Limiting Liability and Seeking Indemnification

Under the Proposed Rules, a private fund adviser or its affiliate (including the private fund's general partner) would be prohibited 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.

This Proposed Rules represent an expansion from concerns the SEC has previously raised with respect to “hedge clauses” in the context of retail investors. In 2019, the SEC cautioned that “there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with those antifraud provisions, where the hedge clause purports to relieve the private fund adviser from liability for conduct as to which the client has a non-waivable cause of action against the private fund adviser provided by state or federal law” but acknowledged that whether “a hedge clause in an agreement with an institutional client would violate the Advisers Act's antifraud provisions will be determined based on the particular facts and circumstances.”⁴ The Proposed Rule's outright prohibition on the inclusion of hedge clauses in private fund advisory agreements and governing documents represents a departure from this prior view -- even the most sophisticated investors in large institutional funds would be prohibited from agreeing to the proscribed liability limitations.

Moreover, the Proposed Rules would not just prohibit hedge clauses that purport to limit the scope of a private fund adviser's non-waivable fiduciary duty under the federal securities law but would further limit the ability to limit liability for acts of negligence (in addition to willful misfeasance and bad faith). Because the conduct that supports a finding of gross negligence generally constitutes more serious and more clearly definable misconduct than negligence, if adopted as proposed, private fund managers will likely be required to amend existing investment management agreements and private fund governing documents, which typically limit the private fund adviser's liability except to the extent that the private fund adviser has acted with gross negligence. In addition, the Proposed Rules' prohibition does not appear limited to prohibiting indemnification upon an independent determination that the prohibited conduct constitutes negligence, potentially opening up the doors to a broad set of disputes as to whether the private fund adviser's conduct constituted negligence at all.

Certain Non-Pro Rata Fee and Expense Allocations

The Proposed Rules would prohibit certain fees and expenses related to a portfolio investment or potential portfolio investment from being charged on a non-pro rata basis when multiple private funds and other clients advised by the private fund adviser or its related persons have invested or propose to invest in the same portfolio investment. Although the Proposed Rules do not define “pro rata,” they appear to contemplate pro rata allocations based on capital that investors either have invested or have committed to invest. Notably, the Proposed Rules would require private fund advisers to allocate fees and expenses on a pro rata basis regardless of whether a portfolio investment is consummated, meaning that “broken deal” expenses would need to be allocated among all proposed participants in an investment, including co-investors.

Considerations for Private Fund Advisers

The Proposed Rules could have significant ramifications for private fund advisers that utilize co-investment vehicles to raise additional capital for portfolio investment deals. Because the private fund adviser would be required to charge any co-investment vehicle its pro rata share of the fees and expenses associated with any unconsummated investment in which the co-investment vehicle “proposed” to invest, private fund advisers will need to face the challenging question of whether and when a co-investor has proposed to invest in a deal, and they may also face difficulties attracting the additional capital needed to consummate certain investments. Similarly, limited partners that seek single deal co-investment opportunities in funds in which they are invested may be asked to agree to pay their pro rata share of fees and expenses associated with broken deals in those funds. From an administrative standpoint, private fund advisers may have challenges allocating fees and expenses on a pro rata basis for unconsummated portfolio investments, especially in the context of multi-deal co-investment vehicles, and they may also face hurdles collecting expenses from potential co-investors if a co-investment deal does not close.

Charging Fees for Unperformed Services

The Proposed Rules would prohibit a private fund adviser from accelerating or charging a portfolio investment for monitoring, servicing, consulting, or other fees for services that the private fund adviser has yet to perform and does not reasonably expect to perform for the portfolio investment.

The Proposed Rules would not prohibit a private fund adviser from receiving payment for services that the private fund adviser has actually provided, nor would it prohibit a private fund adviser from receiving prepayments for services that it reasonably expects to provide in the future. The private fund adviser, however, would be required to refund any amount paid for services that it ultimately did not perform.

There is a limited exception to the prohibition that would allow a private fund adviser to shift 100% of the benefit of an accelerated portfolio investment fee to investors in the private fund through an offset, rebate, or similar mechanism.

Considerations for Private Fund Advisers

- ***Offsets in excess of management fees:*** The offset exception would only apply where the private fund adviser is able to offset or rebate the full amount of the accelerated portfolio investment fee. Where offsets exceed management fees payable to the private fund adviser, however, certain investors may waive receipt of any such excess due to tax reasons. In addition, where a private fund adviser already utilizes a management fee offset to fund some or all of the general partner's capital commitment to the fund, the amount to be rebated at the end of the term of the fund as a result of accelerated portfolio investment fees may be quite large, and the private fund adviser would need adequate liquidity to fund it.
- ***“Reasonably expects” standard:*** While a commonsense approach to the “reasonably expects” standard may be useful in some instances, it is not always the case that a private fund adviser will know, at the time an acceleration clause is triggered, whether it “reasonably expects” to provide certain services for which the portfolio investment is prepaying. For instance, the private fund adviser and the portfolio company may legitimately and “reasonably expect” to perform services that then, for instance, become unnecessary because of changed circumstances. The SEC has invited comment on whether the Proposed Rules should allow a private fund adviser to charge fees for services it does not reasonably

expect to provide, so long as the private fund adviser satisfies certain disclosure, governance, or other conditions, such as approval by the private fund's limited partner advisory committee or other governing body, or disclosure to investors in the relevant funds. Regardless, under the Proposed Rules, private fund advisers will need to carefully consider structuring consulting and similar relationships with portfolio companies, appropriately memorializing the rationale and terms of such relationships, and, where required, providing appropriate disclosure in fund documents.

Reducing Clawback Amounts by Taxes

The Proposed Rules would prohibit a private fund adviser from providing for a clawback of carried interest net of taxes, whether net of actual taxes or net of a set rate of tax. If this prohibition were adopted, private fund advisers would need to revisit all clawback calculations for funds still in existence to adjust any clawback amounts due to investors in the fund.

Clawback provisions are typical in private equity and venture capital funds where carried interest is paid on an interim basis. Calculating such provisions on a post-tax basis is common, in recognition of the fact that recipients of carried interest must pay such taxes and often will not be able to recoup tax payments in the event of a clawback. Adoption of the Proposed Rules will require private fund advisers to reassess how and when carried interest is allocated to recipients and with what disclosures regarding tax consequences and return obligations. A carried interest recipient may nevertheless derive a tax benefit from a capital loss upon payment of the clawback, to the extent the capital loss can offset unrelated capital gains in the clawback year or be carried forward. Thus, where the Proposed Rules would increase a clawback it would also increase the potential tax benefit related to the payment.

Borrowing From a Private Fund Client

The Proposed Rules would also prohibit a private fund adviser from borrowing any assets or otherwise seeking an extension of credit from a private fund client. We note that, in practice, such principal transactions are generally prohibited under most private fund documents currently; certain funds, however, allow these types of transactions subject to advisory committee approval, which would no longer be available. The Proposed Rules would not prohibit private fund advisers from establishing a subscription line of credit on behalf of the fund if a third-party lender funds the line.

Private Fund Adviser-Related Compliance Fees and Expenses

The Proposed Rules also seek to prohibit private fund advisers from charging private funds for fees and expenses associated with the regulatory and compliance activities of the private fund adviser or its related persons, including expenses incurred in connection with examinations or investigations by a regulatory or governmental authority. In the Proposing Release, the SEC distinguishes between fees and expenses directly related to the compliance activities of a private fund, which a private fund adviser would be permitted to pass through to a fund, and fees and expenses incurred by the adviser in connection with examinations or investigations of the private fund adviser or the regulatory or compliance fees of the private fund adviser or its related persons, such as those associated with preparing and filing the private fund adviser's Form ADV.

Over the past several years, it has become more common for private fund advisers, and particularly emerging and mid-sized private fund advisers, expressly to provide for a portion of compliance and regulatory expenses to be

paid for by the funds they manage by including such expenses in the definition of partnership expenses. The Proposed Rules would end this practice.

Considerations for Private Fund Advisers

- *Effect on clawbacks and carried interest:* As previously noted, the Proposed Rules would create an obligation on behalf of private fund advisers to reconsider both (i) how clawback amounts are calculated for their preexisting funds, and (ii) when and how their funds allocate carried interest to carried interest recipients. Any process changes in light of this second consideration might also require corresponding updates to offering document disclosure on carried interest.
- *Identification of expenses:* Although the SEC's guidance delineating the treatment of private fund adviser-related and fund-related compliance expenses is helpful, in practice the distinction between private fund adviser and fund fees and expenses can be very uncertain. This is especially true in a situation where a private fund adviser may allocate such expenses among several private funds. For example, expenses associated with a compliance system that is exclusively used to track permissible investments for several private funds could reasonably be considered a private fund adviser expense or an expense directly related to the management of the relevant private funds. In the Proposing Release, the SEC suggested that, where an expense is not clearly a private fund adviser or a fund expense, the private fund 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."
- *Disclosures:* The SEC has invited comment on whether it should make an exception for situations where a private fund adviser discloses to investors that the fund will bear such fees and expenses. Pending any additional guidance, private fund advisers should take an opportunity to review what fees and expenses they currently allocate to private funds as well as related disclosures to investors.

REQUIRED QUARTERLY REPORTING

The Proposed Rules would require a registered private fund adviser to distribute a quarterly statement to private fund investors that includes, in table format at both the fund level and the portfolio level:

- A detailed accounting of all fees and expenses paid to the private fund adviser and/or its related persons, including any management fee offsets.
- Any other fees and expenses that portfolio investments pay to the private fund adviser and its related persons.
- Certain portfolio company ownership and performance information, including:
 - For open-end funds, annual net total returns since inception, average annual net total returns, and quarterly net total returns.
 - For closed-end funds, gross and net internal rate of return and gross and net multiple of invested capital.

The private fund adviser would be required to distribute these reports to investors within 45 days following the end of the applicable quarter. The SEC expects these requirements would lower the expenses of and burden on

investors associated with monitoring expenses, performance, and conflicting arrangements and improve investors' ability to negotiate fund terms and evaluate services provided by private fund advisers and other service providers. Of note, the SEC considered, but elected not to require, reporting at the investor level. The lack of this reporting would blunt the transparency benefit that this proposal would provide to investors.

Considerations for Private Fund Advisers

Over the last several years, private fund advisers already have increased both the frequency and level of detail of reporting to investors in response to increased investor requests and a general industry trend toward greater transparency. Accordingly, the Proposed Rules likely would not result in dramatic operational changes for most private fund advisers. Private fund advisers should consider the following:

- **Timing:** Private funds commonly provide quarterly financial reporting to investors, generally within 45 to 60 days following the end of the applicable quarter. Private fund advisers would need to assess their ability to prepare these reports, which may not currently include all of the information prescribed under the proposed requirements, on a tighter timeline, giving consideration to additional effort and resources that may be needed where reporting obligations exceed the private fund adviser's current practices.
- **Funds of funds:** Funds of funds that rely on underlying fund managers for reporting information would benefit from additional guidance as to whether the reports could include information based on the most current underlying fund estimates, which could lag by a quarter or more depending on the underlying fund, or whether fund of funds will be permitted additional time to provide their reports, similar to the extension that funds of funds receive to deliver their audited financials to underlying investors under Rule 206(4)-2 under the Advisers Act (the Custody Rule).
- **Offering document disclosures:** Many private fund advisers would need to review and update their funds' governing documents for changes to the frequency or content of reports to investors.

ANNUAL AUDIT REQUIREMENT

The Proposed Rules would require registered private fund advisers to obtain and distribute promptly to investors an annual audit of each of their private funds, prepared in accordance with U.S. GAAP (or, for foreign private funds, financial statements containing substantially similar information) by an independent public accountant registered with and subject to regular inspection by the Public Company Accounting Oversight Board. In addition, a private fund adviser would be required to enter into an agreement with the auditor requiring the auditor to notify the SEC Division of Examinations if the private fund adviser terminates the auditor's contract or if the auditor issues a modified opinion.

Subadvisers to private funds would also be required to take "all reasonable steps" to cause a subadvised private fund controlled by an unaffiliated private fund adviser to undergo an audit in satisfaction of the Proposed Rules.

Considerations for Private Fund Advisers

- **Custody rule compliance gaps:** The audit requirement largely—though not completely—overlaps with existing audit practices of many private fund advisers under the Custody Rule, such that private fund advisers that deliver audited financials or opt to conduct a surprise accounting firm examination for purposes of compliance with the Custody Rule will not automatically be in compliance with the Proposed

Rules. Most notably, the Proposed Rules do not allow private fund advisers to utilize the surprise examination option under the Custody Rule in lieu of obtaining an audit.

- **Timing:** The Proposed Rules would require that the private fund adviser make “prompt” delivery of a fund’s audited financial statements after the completion of the audit, but neither the Proposed Rules nor the Proposing Release contain further guidance as to what timing is required to meet this standard, and the SEC elected not provide any “specific deadline.” The SEC specifically notes, however, that the 120-day period in the Custody Rule will not necessarily satisfy this requirement.
- **Subadvisers:** Subadvisers, especially third-party subadvisers, to private funds should review their subadvisory agreements and relationships to take “all reasonable steps” to require compliance with the audit requirement for each private fund that they subadvise. Notably, private fund advisers acting as subadvisers to a private fund will typically not have custody, as that term is defined in the Custody Rule, of the fund, and unregistered private fund advisers may object to fund investors bearing the cost of an audit to accommodate regulatory requirements imposed on the subadviser by the SEC. Collateral managers of collateralized loan obligations (CLOs) should also pay close attention to this requirement, as many collateral managers also take the position that they do not have custody under the Custody Rule, and CLOs often are not subject to audit.

ADVISER-LED SECONDARIES REQUIREMENTS

Finally, the Proposed Rules would require a registered private funds adviser, in connection with certain private fund adviser-led secondaries, to obtain and distribute prior to close:

- A third-party opinion that the price the private fund adviser offers is fair (a Fairness Opinion).
- A summary of material business relationships that the private fund adviser or its related persons has had over the prior two years with the opinion provider.

The Proposed Rules define the transactions that would fall within the scope of these new requirements as transactions that the private fund adviser or its related persons initiate and that offer investors the option either to sell their interests or to convert or exchange their interests for interests in another vehicle that the private fund adviser or its related persons advise.

For such transactions, private fund advisers would need to obtain a Fairness Opinion from an unrelated third party that provides such opinions in the ordinary course of business and provide disclosure of the private fund adviser’s material business relationships with the opinion provider.

Considerations for Private Fund Advisers

Private fund advisers should consider whether they engage in transactions that may fall within the scope of the Proposed Rules. For example, does the private fund adviser actively “commence” a process intended to provide liquidity in exchange for interests in a fund or in a continuation vehicle? Alternatively, does the private fund adviser merely facilitate a secondary sale of a fund interest in response to an unsolicited request from investors? If the Proposed Rules are adopted as proposed, private fund advisers may consider developing policies designed to distinguish one situation from the other.

* * *

In some ways, the Proposed Rules would codify existing practices observed by many private fund advisers. But, in many other ways, private fund advisers will view the Proposed Rules as imposing material changes to their operations, and private fund advisers and investors, as applicable, will need to consider how the Proposed Rules impact their relationships, the terms pursuant to which investors invest, and private fund advisers' abilities to develop novel investment products tailored to investor needs. We anticipate that smaller and emerging managers will be the most impacted by many of the Proposed Rules, particularly in connection with capital raising and the cost of compliance.

FOOTNOTES

The authors would like to thank Matt Hevert and Wes Gangi for contributing to the writing of this alert.

¹ [Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955; File No. S7-03-22](#), (the Proposing Release).

² The full list of submitted comments may be found on the SEC website. See [Comments on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955; File No. S7-03-22](#), (last visited Mar. 29, 2022).

³ See [Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Release No. IA-5248; File No. S7-07-18](#), at n70, ("As discussed above, institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications.").

⁴ *Id.* at n.31. Earlier this year, the SEC brought an enforcement action against an investment adviser for including an inappropriate "hedge clause" in its advisory agreements with retail clients. See *In re Comprehensive Cap. Mgmt., Inc.*, Advisers Act Release No. 5942 (Jan. 11, 2022).

KEY CONTACTS



ED DARTLEY
PARTNER

NEW YORK
+1.212.536.4874
ED.DARTLEY@KLGATES.COM



KENNETH HOLSTON
PARTNER

BOSTON
+1.617.261.3154
KENNETH.HOLSTON@KLGATES.COM



RUTH E. DELANEY
PARTNER

LOS ANGELES
+1.310.552.5068
RUTH.DELANEY@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.