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Substantial Changes to the Private Fund Regulatory Regime Proposed

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The Securities and Exchange Commission (SEC) has recently engaged in a flurry of rulemaking activity that would significantly impact asset managers that advise private funds. The SEC on February 9, 2022 voted three to one to propose a set of new rules and rule amendments (the Proposed Rules) that if adopted, would represent the most significant changes to the regulation of private funds and their advisers since the Dodd-Frank Act and a fundamental shift in how private funds are regulated.[1] The Proposed Rules would impose substantive regulation on an industry that currently is subject to a largely disclosure-based regime. Notably, the Proposed Rules would both prohibit and require different types of contractual provisions that are typically subject to negotiation. This would reduce the ability of sophisticated private parties to negotiate the terms of their investments into private funds, including with respect to such matters as the amount of risk that each party is willing to bear. The Proposed Rules would also impact non-US advisers offering non-US products, managers to accounts that are "substantially similar pools of assets" to private funds (for example, collateralized loan obligations), as well as advisers to investment companies registered under the Investment Company Act of 1940, as amended (the 1940 Act). Compliance with the Proposed Rules would likely increase fund expenses paid by investors and create additional barriers to entry to new managers.

This shift in regulatory approach would have ramifications beyond the specific proposed restrictions. The Proposed Rules, if adopted, likely will result in a major, industry-wide efforts to revise and renegotiate the governing documents of funds. The Proposed Rules likely will have an adverse impact on the pricing and availability of private funds generally, with the potential for significant and disparate impacts on a number of types of investment strategies. Given the compliance costs, non-US advisers may weigh the costs of complying with the Proposed Rules compared to the assets that they receive from US investors. This creates potential for a limitation in the number of private funds available for US investors.

This article provides both a discussion and an analysis of certain material aspects of the Proposed Rules. It concludes with presenting issues that advisers should be considering now.

Summary of the Proposed Rules

In the proposing release (Release), the SEC stated that its goal is to protect private fund investors "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." 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" where the SEC "believe[s] 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."

As discussed, the Proposed Rules have a wide range of impact on private funds. Specifically, the Proposed Rules would require the following:

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 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 Investment Advisers Act of 1940, as amended (the Advisers Act) (Private Fund Advisers)) from engaging in certain activities (for example, 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 (for example, 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.

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

A more in-depth discussion of the above items follows with related recordkeeping amendments described in each section.

Quarterly Statements

While advisers are not currently 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." Proposed Rules would standardize private fund reporting, with Private Fund RIAs being required to prepare and distribute quarterly statements to private fund investors within 45 days following a quarter end. These reports could be electronically delivered in accordance with the existing SEC guidance on electronic delivery.[2]

The quarterly statements would include: (1) standardized information that details certain fee and expense information; and (2) standardized reporting of performance information. Some of this information would need to be provided in a table format that is set forth in the Proposed Rules. The Proposed

Rules also set forth definitions of the performance information that would need to be included in the performance information. The SEC proposed the table format and defined terms to promote standardization and comparative review by investors.[3] 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.

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-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.

Fee and Expense Information

The fee and expense information, as proposed, would consist of a form private fund-level disclosure table and form portfolio investment-level disclosure table. The Proposed Rules would also require "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 (for example, fixed, asset-based or performance-based) on which each type of compensation is based. In addition to the requirements set forth in the Proposed Rules, Private Fund RIAs would be required to provide section cross-references to the private fund's governing documents to allow each investor to seek additional information by reviewing those provisions and disclosures.

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 (for example, "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 (for example, "organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses") other than those disclosed as adviser compensation; and
- *Fee reductions*. The 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:"[4]

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- *Portfolio Investment Compensation*. All compensation, fees and other amounts (for example, "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 would have to 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;[5] and
- *Ownership Percentage*. A list of the quarter-end percentage ownership of the private fund in each covered portfolio investment.[6]

Performance Disclosure

The performance information would need to be standardized dependent on whether the fund is liquid or illiquid, and a discussion of each type follows.[7] Further, Private Fund RIAs would be required to "display the different categories of required performance information with equal prominence." In addition to the required information set forth in the Proposed Rules, Private Fund RIAs could include additional types of performance metrics. Private Fund RIAs would be required to disclose the criteria used and assumptions made in calculating performance (for example, whether dividends were reinvested, assumed fee rates) "within the quarterly statement" and not in a separate disclosure.

Liquid Funds. For liquid funds, a Private Fund RIA 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.

Illiquid Funds. For illiquid funds, the Private Fund RIA would be required to include, since inception[8] of the illiquid fund, computed without the impact of any fund-level subscription facilities, the following information:[9]

- *Fund-level performance*. Gross[10] internal rate of return (IRR)[11] and gross multiple of invested capital (MOIC)[12] and net IRR and net MOIC;
- *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."

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 part of their compliance with Advisers Act Rule 206(4)-2 (Custody Rule).[13] The Proposed Rules 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 audit at least annually and upon liquidation, as well as distribute the audited financial statements "promptly" to fund investors. Audited financial statements would have to be prepared in accordance with US GAAP or, in the case of financial

statements of private funds organized under non-US 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 US GAAP and reconcile the material differences with US GAAP. The Proposed Rules include specific requirements regarding the audit and distribution of the audited financial statements. A Private Fund RIA would need to have a written agreement with the auditor to allow the auditor to report certain prescribed matters to the SEC.

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 this Proposed Rule is "based on the custody rule and contains many similar or identical requirements," there are some notable differences: (1) it does not provide an alternate means of compliance; (2) it has different written agreement and notification provisions; (3) its 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's requirements; and (4) annual financial statements would need to be delivered "promptly" 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 Release 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 (that is, recipient, address, date sent, delivery method); and document the steps it has taken to cause the private fund to undergo an audit that complies with the Proposed Rules.

Adviser-Led Secondary Transactions

Currently, there are no specific requirements for, nor any prohibition or limitation on, adviser-led secondary transactions, so long as the adviser meets general Advisers Act requirements related to cross trades and complies with the Advisers Act's antifraud provisions. The terms of secondaries are often driven by negotiated contracts. The Proposed Rules 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 Rules, 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 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 Rules would also 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

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the Private Fund RIA (that is, 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 (for example, additional fees) from their completion as a result. The SEC indicated that this provision would ensure 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 Proposed Rules would also 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 (that is, recipient, address, date sent, delivery method).

Certain Other Prohibited Activities

Currently, the regime governing private funds largely does not prohibit activities that can be fully and fairly disclosed to, and thus consented to, by investors. Signaling a significant shift in regulatory approach, the Proposed Rules include 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 (for example, 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 (for example, an LPAC) has consented to them.

Specifically, the Proposed Rules would prohibit Private Fund Advisers from engaging directly or indirectly (that is, 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") would be prohibited. The Release notes, however, that this prohibition would not apply if the Private Fund Adviser charges fees to a portfolio investment for services that actually are performed or to advance payments for services the Private Fund Adviser reasonably expects to provide, in each case so long as it would be required under the Proposed Rules to refund any prepaid fees for services that ultimately are not performed. In addition, the Release states that the Proposed Rules are not intended to prohibit a Private Fund 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 percent 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" would also be prohibited. 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 (for example, 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

Any "clawback" (that is, any obligation requiring the adviser to return some or all of the performance-based compensation[14] to the fund under the fund's governing documents) could not be reduced 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

The Proposed Rules would prohibit Private Fund Advisers from seeking reimbursement, indemnification or exculpation from a fund advised by the Private Fund Adviser for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness. 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.[15] 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."[16]

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 and other clients advised by the adviser" (or its related persons) have invested in, or propose to invest in, the same portfolio investment would also be prohibited. There would be no exceptions to this prohibition. The Release states that this prohibition would apply to prospective investments that are not consummated (for example, "broken-deal" expenses would have to be allocated *pro rata* among all funds that proposed to invest). However, the Release indicates the Proposed Rules would not prohibit a Private Fund 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

A Private Fund Adviser would be prohibited from "[b]orrowing 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 these activities should be prohibited as they "incentivize" Private Fund Advisers to put their own interests first, particularly to the detriment 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 is that these "prohibitions are necessary given the lack of governance mechanisms that would help check overreaching by private fund advisers." The Proposed Rules would not prohibit a Private Fund 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.

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

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arrangements and related conflicts be fully and fairly disclosed. The Proposed Rules would prohibit Private Fund Advisers 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.[17] Additionally, the Proposed Rules 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."

A Private Fund Adviser would be prohibited from contractually agreeing to the following "preferential terms:" (1) preferential redemption rights that the adviser reasonably expects will have a material, negative effect on other investors; (2) preferential information rights on portfolio holdings or exposures to any investor if the adviser reasonably expects that this information would have a material, negative effect on other investors; and (3) unless such treatment is disclosed to prospective investors prior to investing in a private fund and existing investors at least annually, any other preferential treatment in side letters or other arrangements. The Release indicates that whether a particular right is "preferential" and whether a preferential term or information provided on a selective basis could be reasonably expected 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 (for example, recipient, address, dates sent, delivery method).

RIA Annual Compliance Reports

Currently, Advisers Act Rule 206(4)-7 (the 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.[18] The Proposed Rules 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 (for example, quarterly), those reports, taken together, would constitute an annual compliance report that satisfies the requirements of the Proposed Rules.

Potential Implications

As discussed above, if adopted, the Proposed Rules would be the most sweeping change to the private fund regulatory regime since the SEC implemented rules requiring the registration of most Private Fund Advisers under the Dodd-Frank Act and would reflect a transformation in the SEC's approach to the regulation of private funds specifically and the Advisers Act more generally. Notably, the proposal would impose a substantive regulatory regime, including restrictions without meaningful exceptions, on an industry that operates under a regulatory system that reinforces and fills in the gaps in market-determined outcomes, primarily through disclosure requirements and by defining the scope of and enforcing flexible fiduciary principles. This regulatory framework has relied on and empowered market forces to protect investors through arm's-length negotiation. If adopted, the Proposed Rules would mold the advisory relationship between an adviser and the fund and reduce the ability of sophisticated private parties to negotiate critical terms of their investments into private funds with Private Fund Advisers in their own interests. In short, the existing regime uses full and fair disclosure within flexible fiduciary principles in respect of the advisory relationship to manage conflicts of interest, while the new Proposed Rules use restrictions to eliminate common practices and mandate other practices that go to the heart of what large

institutional investors such as pension plans seek, and would negatively impact the bargaining power and terms received by those very investors that the SEC seeks to protect.

Expanding on the themes of a fundamental shift in the regulatory approach of the SEC and the specific restrictions limiting negotiations set forth in the Proposed Rules, the comment letters made public thus far echo these concerns and raise alarms for the unintended consequences that imposition of such approach and restrictions could cause.

As the Proposed Rules would mandate practices that are commonplace, without leaving room for variations due to the type of strategy, the proposed restrictions neglect investor preference or how managing a fund works in practice. For example, with respect to the quarterly reporting requirements, there is an argument that quarterly statements need not be mandated as they are already common and reporting is a point upon which the parties negotiate and should be tailored to the strategy and the underlying investments. Similarly, mandatory GAAP audits are frequently used by Private Fund RIAs to comply with the Custody Rule; however, it remains unclear how a Private Fund RIA would be able to comply with this requirement in the event that one of its private funds holds one or more assets (for example, underlying portfolio companies) for which a valuation cannot be determined in a manner that is consistent with GAAP. Similarly, non-pro rata fees and expenses often are used to fairly and equitably allocate fees and expenses with consideration given to the parties that actually benefit from such expenditures; the prohibition on non-pro rata fees and expenses could have the opposite effect and result in unfair treatment as, for example, all investors would need to bear the expenses caused by a subgroup of investors' tax structuring needs.

Further, the restrictions on preferential treatment received pushback from several investors in comment letters that explained that they need preferential treatment to fulfill the governance, policy and similar requirements to which they are subject. Additionally, both advisers and investors recognized the additional costs associated with mandating a negligence standard for indemnification and exculpation standards.

As the SEC reaches its hand further into the private fund marketplace, there will be unintended consequences and a reordering of obligations and their costs.

Considerations and Next Steps

The SEC received numerous substantive comments on the Proposed Rules during the initial comment period, which ended April 25, 2022. The SEC has since re-opened the comment period for an additional thirty days, which ended on June 13, 2022. In addition, the Release indicates 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. These withdrawals and modifications would likely be reflected in the final rule release. Once adopted, advisers would likely have a transition period to comply with the final rules, and the Release proposes a one-year transition period.

The final adoption of the rules, however, could be delayed through litigation challenges. 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." While it is not possible to predict the course of litigation, the SEC's reliance on Section 211(h) of the Advisers Act and the reopening of the

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comment period might each be intended to prevent a successful litigation challenge. How any particular litigation challenge would proceed and the extent to which such challenge would potentially impact the adoption of the final rules remains to be seen.

Regardless of the uncertainty in both the scope of the final rules and the timing to comply with the final rules, advisers might consider if any of the following actions could benefit their longer-term planning in respect of their existing and new private fund clients (noting, of course, that the effect of the Proposed Rules is not limited only to private funds):

- Review existing fund governing documents, including side letters and similar arrangements with investors, to understand the terms that could be impacted by the Proposed Rules, and whether any existing disclosure should be enhanced.
- Review new funds' and amendments to existing fund governing documents with consideration given to how the Proposed Rules might impact them, and if addressing these considerations now is prudent or practicable.
- Consider how specific requirements could impact firm operations, resources and existing service provider agreements. For example, compliance with the reporting requirements could require firms to set up new procedures and processes for reporting to investors, which could involve negotiations with their administrators (or other third parties) for such services, and these steps will likely involve initial start-up costs and ongoing running costs. Advisers should also review how the defined terms in the reporting requirements would apply to their operations.
- Review internal compliance procedures to incorporate any new obligations or prohibitions on particular activities into the adviser's compliance program.
- Review with investor relations to understand how the Proposed Rules may affect existing and new investor relationships.
- Consult with legal counsel to address concerns raised in how the Proposed Rules may affect operations, fund terms and investors.

Regardless of the form in which the Proposed Rules are adopted, they will likely have a significant and lasting impact on private funds, as well as represent a significant change in the regulatory framework of private funds and their advisers.

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NOTES

1. *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, SEC Proposed Rules, SEC Rel. No. IA-5955 (Feb. 9, 2022), *https://www.sec.gov/rules/proposed/2022/ia-5955.pdf*; Dodd-Frank Wall Street Reform and Consumer Protection Act section 913(h) Pub. L. No.111-203, 124 Stat. 1376 (2010) (the Dodd-Frank Act). At times, this Article tracks the language in the Release, and quotations in this Article refer to the Release unless otherwise noted.
2. The Proposed Rules would require the quarterly reporting to begin no later than the second full calendar quarter after fund launch.
3. The Proposed Rules 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."

[4] 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.

[5] 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."

[6] 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."

[7] 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 US 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."

[8] 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.

[9] 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 Rules 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."

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

[11] 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)."

[12] 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

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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." Further, the definition is intended to measure "how much" rather than "when" the fund generates a return.

13 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.

14 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."

15 Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Interpretation (June 5, 2019) (IA Standard of Conduct Interpretation), *https://www.sec.gov/rules/interp/2019/ia-5248.pdf.*

16 Observations from Examinations of Private Fund Advisers, SEC Division of Examinations Risk Alert (Jan. 27, 2022), *https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf.*

17 The Release includes a definition of "substantially similar pool of assets," which is defined as a "pooled investment vehicle (other than an investment company registered under the 1940 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 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 Rule 3a-7 under, the 1940 Act. Whether the fund and another pool have substantially similar investment policies, objectives and restrictions would require a facts-and-circumstances analysis.

18 *See Compliance Programs of Investment Companies and Investment Advisers*, SEC Final Rule, SEC. Rel. Nos. IA-2204 and IC-26299 (Dec. 17, 2003), *https://www.sec.gov/rules/final/ia-2204.htm*.

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