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SEC PROPOSES NEW PRIVATE FUND ADVISER RULES

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On February 9, 2022, the Securities and Exchange Commission ("**SEC**") proposed a series of new rules under the Investment Advisers Act of 1940, as amended ("**Advisers Act**") that would impose significant new regulatory requirements, obligations, and restrictions on private fund advisers. If adopted, the proposed new rules would:

- Require private fund advisers to provide private fund investors with quarterly reports that set forth detailed information regarding private fund performance, fees and expenses;
- Require private fund advisers to obtain an annual audit for each private fund;
- Require private fund advisers, in connection with an adviser-led secondary transaction, to provide investors with a fairness opinion and summary of material business relationships between such adviser and the opinion provider;
- Prohibit all private fund advisers from engaging in certain practices and activities that the SEC deems to be contrary to the public interest;
- Prohibit all private fund advisers from providing certain types of preferential treatment that have a material negative effect on other investors, while also prohibiting any other types of preferential treatment unless properly disclosed to investors; and
- Require all advisers, including those who do not advise private funds, to document their annual compliance reviews pursuant to Rule 206(4)-7 under the Advisers Act.

These proposed new rules are designed to protect those who directly or indirectly invest in private funds by increasing transparency into certain practices, imposing requirements with respect to certain practices that have the potential to harm investors, and prohibiting certain activity or practices that the SEC believes are contrary to the public interest and the protection of investors. A detailed overview of the proposed new rules is set forth below.

SUMMARY OF PROPOSED NEW RULES

Proposed Rule 211(h)(1)-2 – Delivery of Quarterly Statements

Proposed Rule 211(h)(1)-2 would require an SEC-registered private fund adviser to prepare and distribute quarterly statements, in table format, to all private fund investors within 45 days of each calendar quarter end.

Private Fund Fees and Expenses

- The quarterly statement would be required to disclose the method by which payments, expenses, allocations, rebates, waivers, and offsets are calculated while providing cross-references to the relevant sections of the applicable fund documents. Private fund advisers would be required to list each specific category of expense as a separate line item. Moreover, the proposal indicates that lumping fund expenses into broader categories generally would not be permitted.

Compensation Received by the Private Fund Advisers and Persons Related to the Management of Private Funds

- The quarterly statement would be required to include a detailed accounting of all compensation, fees, and other amounts paid or allocated by a fund to its investment adviser, as well as any of the investment adviser's related persons. The statement would need to include the amounts both before and after applications of any offsets, rebates, or waivers.

Private Fund Performance

- Within each quarterly statement, investment advisers would be required to include standardized fund performance information tailored to the liquidity characteristics of the private fund. In particular, the performance disclosure requirements of the proposed quarterly statement rule vary depending on whether a private fund is an "illiquid fund" or a "liquid fund."

- Illiquid funds are defined as private funds that:

  (i) have a limited life;

  (ii) do not continuously raise capital;

  (iii) are not required to redeem interests upon request of investors;

  (iv) have, as a predominant operating strategy, to return the proceeds from disposition of investments to investors;

  (v) have limited opportunities, if any, for investors to withdraw before termination of the funds; and

  (vi) do not routinely acquire (directly or indirectly) market-traded securities and derivative instruments as part of their investment strategy.

- Private funds that fall into the definition of a "illiquid fund" generally are closed-end funds that do not offer periodic withdrawal rights or options to investors. For each illiquid fund, the quarterly statement would be required to provide the gross and net internal rate of return and gross and net multiple on invested capital for such illiquid fund to capture performance from the fund's inception through the end of the current calendar quarter.

- A liquid fund would be any private fund that does not fall under the definition of an illiquid fund. Private funds that fall within the liquid fund definition generally allow or permit withdrawals on a periodic basis, such as quarterly, monthly or semi-annually. Hybrid funds that are mainly illiquid generally would not fall under the definition of an illiquid fund and thus would generally be considered liquid.

    - For each liquid fund, the quarterly statement would provide annual net total returns since inception, average annual net total returns over prescribed time periods, and quarterly net total returns for the current calendar year.

<u>Proposed Rule 206(4)-10</u> – Mandatory Private Fund Adviser Audits

Proposed Rule 206(4)-10 would require all SEC-registered private fund advisers to cause the private funds they advise to undergo financial statement audits that satisfy the requirements of the rule at least annually and upon liquidation. If an adviser provides advisory services with respect to a private fund that such adviser neither controls, nor is controlled by or under the common control of such adviser, then the adviser would only be required to take all reasonable steps to cause such fund to undergo an annual audit satisfying the requirements of the proposed new rule. It is unclear exactly what actions or steps would need to be undertaken by an adviser to constitute “reasonable steps” for purposes of this proposed new rule.

While a majority of private funds already undergo annual audits pursuant to Rule 206(4)-2 under the Advisers Act (the “**Custody Rule**”), the proposed rule differs from the Custody Rule in certain significant respects. First, while the Custody Rule permits advisers to obtain surprise examinations in lieu of annual audits, the proposed rule would require *all* SEC-registered private fund advisers to have their private funds undergo financial statement audits, including those funds that currently choose to undergo surprise examinations for Custody Rule compliance purposes. Second, the proposed rule would require a private fund adviser or private fund to contractually require its auditor to notify the SEC upon the auditor’s termination or issuance of a qualified opinion.

<u>Proposed Rule 211(h)(2)-2</u> – Requirements for Adviser-Led Secondary Transactions

Proposed Rule 211(h)(2)-2 would make it unlawful for an SEC-registered investment adviser to complete an Adviser-Led Secondary Transactions (as defined below) with respect to any private fund, unless such adviser, prior to the closing of such transaction, distributes the following to all private fund investors:

(i) a fairness opinion from an independent opinion provider; and

(ii) a summary of any material business relationships the investment adviser, or any related persons has, or has had within the past two (2) years, with the independent opinion provider.

For purposes of this proposed new rule, “**Adviser-Led Secondary Transactions**” are defined as transactions initiated by the investment adviser or any of its related persons that offer the private fund’s investors the choice to either as:

(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.

For example, a transaction in which an adviser arranges for one or more investors to purchase fund interests directly from existing investors as part of a “tender offer” or similar transaction, generally would constitute an adviser-led secondary transaction subject to the requirements of this proposed rule. Proposed Rule 211(h)(2)-2 is intended to check against an adviser’s potential conflict of interest when structuring a transaction from which the adviser may profit. If this rule is adopted, Adviser-Led Secondary Transactions will be more expensive and time-consuming, possibly incentivizing advisers to avoid Adviser-Led Secondary Transactions.

<u>Proposed Rule 211(h)(2)-1</u> – Certain Prohibited Practices and Activities

Proposed Rule 211(h)(2)-1 would prohibit all private fund advisers (whether SEC-registered or exempt from SEC registration), with respect to private funds and private fund investors, from directly or indirectly engaging in certain activities and practices the SEC deems contrary to the public interest for the protection of investors. In the SEC's view, prohibiting these activities and practices would address conflicts of interest that could lead to fraud and investor harm because they incentivize an adviser to place its own interests ahead of the private fund and its investors. In particular, the Proposed Rule 211(h)(2)-1 would prohibit the following activities and practices.

Prohibited Fees and Expenses

- Charging (i) certain fees and expenses to a private fund or portfolio investment, including accelerated monitoring fees or other fees in respect of services an adviser does not, or does not reasonably expect to, provide to an investment or private fund; (ii) fees or expenses incurred in connection with an examination or investigation of the adviser or its related persons by the SEC or other governmental agencies or authorities; or (iii) regulatory and compliance expenses of an adviser or its related persons;

Reduction of Clawback Amounts for Certain Taxes

- Reducing the amount of any adviser or general partner carried interest clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons or their respective owners or interest holders;

Limits on Adviser Exculpation and Indemnification

- Seeking reimbursement, indemnification, exculpation, or limitation of an adviser's liability, with respect to the adviser's services to a private fund, from any private fund or the private fund investors for: (i) a breach of fiduciary duty; (ii) willful misfeasance; (iii) bad faith; (iv) negligence; or (v) recklessness;

Certain Non-Pro Rata Fee and Expense Allocations

- Charging or allocating fees and expenses related to an investment or potential 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 have proposed to invest, in the same investment (such as co-investors or potential co-investors); and

Affiliated Borrowing

- Borrowing money, securities, or other fund assets, or receiving a loan or extension of credit, from any private fund.

This proposed rule would prohibit the foregoing activities and practices regardless of whether the private fund's governing documents permit or specifically authorize them, regardless of whether the practices are disclosed to investors, and regardless of whether the private fund investors have consented to or approved such activities or practices.

<u>Proposed Rule 211(h)(2)-3</u> – Preferential Treatment

Proposed Rule 211(h)(2)-3 would prohibit all private fund advisers (whether SEC-registered or exempt from SEC registration) from (i) providing preferential terms to certain investors regarding withdrawals or redemptions from a fund or portfolio transparency; and (ii) providing any other preferential treatment to any investor in a fund unless written disclosures are provided to all prospective and current investors in such fund regarding all preferential treatment provided to other investors in the same fund. Whether any terms are or would be deemed to be “preferential” would depend on the facts and circumstances.

In particular, a private fund adviser would be prohibited from granting an investor in a private fund, parallel fund, or substantially similar pool of assets the right to redeem or withdraw its interest on terms the adviser reasonably expects to have a material negative effect on other investors in that private fund or substantially similar pool of assets (such as a parallel fund or co-investment vehicle). Similarly, an adviser would be prohibited from providing information regarding portfolio holdings or exposures of a private fund or 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 fund or substantially similar pool of assets. In most circumstances, the practical effect of these two proposals would be to prohibit advisers from granting preferential liquidity and portfolio transparency to only certain investors in a fund.

Beyond preferential liquidity or portfolio transparency, preferential treatment would be prohibited unless an adviser provides certain written disclosures regarding such preferential treatment to current and prospective investors. For purposes of this proposed rule, an adviser would be required to describe specifically each applicable preferential treatment to adequately convey its relevance and significance to all investors. For prospective investors, an adviser would be required to provide written notice of such preferential terms to such investors prior to their investment in the applicable fund. For current investors, an adviser would be required to annually distribute written notice if any preferential treatment is provided to an investor since the last notice.

The SEC’s proposal did not include a definition of “preferential,” accordingly, any rights or terms offered or granted to an investor would need to be analyzed and considered on a case-by-case basis depending on relevant facts and circumstances.

<u>Proposed Rule 206(4)-10</u> – Compliance Rule Amendments

While Rule 206(4)-7 under the Advisers Act (the “**Compliance Rule**”) currently requires all SEC-registered investment advisers to “review, no less frequently than annually, the adequacy of their policies and procedures established pursuant to” the Compliance Rule and the effectiveness of their implementation, such annual compliance reviews are not currently required to be documented in writing. Proposed Rule 206(4)-10 would amend the Compliance Rule to affirmatively require all SEC-investment advisers, including non-private fund advisers, to document their annual compliance reviews in writing. This rule is proposed to assist the SEC in assessing an adviser’s compliance, while assisting the SEC in enforcement and identifying potential compliance weaknesses.

The proposed rule does not include specific elements the advisers must include in their documentation, which provides advisers with a certain degree of flexibility in continuing and improving their current policies and procedures.

CONCLUSION

If adopted, these proposed new rules would significantly increase the regulatory, disclosure, and reporting requirements applicable to both registered and unregistered private fund advisers, resulting in dramatic changes to current private fund adviser practices and activities. The proposed new rules are highly controversial, and we expect there will be a tremendous push by private fund managers, industry groups, and others to persuade the SEC to reduce or change various aspects of the proposed new rules. Interested persons must submit any comments and feedback to the SEC regarding the proposed new rules on or before the later of (i) 30 days after publication of the proposed rules in the Federal Register; or (ii) April 11, 2022.

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For more information, or if you have any questions, please contact one of the following Haynes and Boone attorneys:

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