

Private Fund Proposed Reforms



The Securities and Exchange Commission proposed new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act) to enhance the regulation of private fund advisers. The proposed new rules would:

- Require private fund advisers registered with the Commission to provide investors with quarterly statements detailing information about private fund performance, fees, and expenses;
- Require registered private fund advisers to obtain an annual audit for each private fund and cause the private fund's auditor to notify the SEC upon certain events;
- Require registered private fund advisers, in connection with an adviser-led secondary transaction, to distribute to investors a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider;
- Prohibit all private fund advisers, including those that are not registered, from engaging in certain activities and practices that are contrary to the public interest and the protection of investors; and
- Prohibit all private fund advisers from providing certain types of preferential treatment that have a material negative effect on other investors, while also prohibiting all other types of preferential treatment unless disclosed to current and prospective investors.

Additionally, the SEC is proposing to require all registered advisers, including those that do not advise private funds, to document the annual review of their compliance policies and procedures in writing.

Why This Matters

With more than \$18 trillion in gross assets, private funds and their advisers play an important role in our financial markets and the lives of everyday Americans. Some of the largest private fund investors include state, municipal, and private pension plans that provide retirement and other benefits to the American public.

Based on the SEC's experience overseeing private fund advisers and the sector's impact on our financial system, our economy, and American investors' savings, there is a need to enhance the regulation of private fund advisers. The proposed reforms are designed to protect private fund investors by increasing their visibility into certain practices, establishing requirements to address practices that have the potential to lead to investor harm, and prohibiting adviser activity that is contrary to the public interest and the protection of investors.

What this Proposal Would Do

Quarterly Statement Rule

The proposal would require registered private fund advisers to distribute a quarterly statement to private fund investors with a detailed accounting of all fees and expenses paid by the private fund during the reporting period. In addition, the statement would disclose information regarding compensation or other amounts paid by the private fund's portfolio investments to the adviser or any of its related persons.

The proposal also would require advisers to provide information regarding the private fund's performance. For liquid funds, 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. For illiquid funds, the statement would provide the gross and net internal rate of return and gross and net multiple of invested capital for the illiquid fund to capture performance from the fund's inception through the end of the current calendar quarter.

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The proposal is designed to improve the quality of information provided to fund investors and allow them to better assess, monitor, and compare their private fund investments.

Private Fund Audit Rule

The proposal would require registered private fund advisers to cause the private funds they advise to undergo a financial statement audit at least annually and upon liquidation. The proposal would require the audited financial statements to be distributed to investors promptly after the completion of the audit. These audits would provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees, and protect private fund investors against misappropriation of fund assets.

Adviser-Led Secondaries Rule

The proposal would require a registered private fund adviser to obtain a fairness opinion in connection with an adviser-led secondary transaction. In these transactions, advisers often offer existing fund investors the option to sell or exchange their interests in the private fund for interests in another vehicle advised by the adviser. An independent opinion provider would opine on the fairness of the price being offered to the private fund for any assets being sold as part of the transaction. The proposal also would require the adviser to prepare and distribute to the private fund investors a summary of any material business relationships the independent opinion provider has or has had within the past two years with the adviser or any of its related persons. This requirement would provide a check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors.

Prohibited Activities Rule

The proposal would prohibit all private fund advisers from engaging in certain activities and practices that are contrary to the public interest and the protection of investors. These practices include:

- Charging certain fees and expenses to a private fund or its portfolio investments, such as fees for unperformed services (e.g., accelerated monitoring fees) and fees associated with an examination or investigation of the adviser;
- Seeking reimbursement, indemnification, exculpation, or limitation of its liability for certain activity;
- Reducing the amount of an adviser clawback by the amount of certain taxes;
- Charging fees or expenses related to a portfolio investment on a non-pro rata basis; and
- Borrowing or receiving an extension of credit from a private fund client.

Prohibiting these practices would address conflicts of interest that could reasonably lead to fraud and investor harm because they incentivize an adviser to place its interests ahead of the private fund's interests.

Preferential Treatment Rule

The proposal would prohibit all private fund advisers from providing preferential terms to certain investors regarding redemptions from the fund or information about portfolio holdings or exposures. It also would prohibit all private fund advisers from providing other preferential treatment unless disclosed to current and prospective investors. This proposal is designed to protect investors by prohibiting specific types of preferential treatment that have a material, negative effect on other investors.

Books and Records Rule Amendments

The proposal includes amendments to the books and records rule under the Advisers Act that require advisers to retain records related to the proposed rules. The amendments would facilitate the SEC's ability to assess an adviser's compliance with the proposed rules.

Compliance Rule Amendments

The proposal includes amendments to the compliance rule under the Advisers Act that require all registered advisers, including those that do not advise private funds, to document their annual review in writing.

Additional Information:

The public comment period will remain open for 60 days following publication of the proposing release on the SEC's website or 30 days following publication of the proposing release in the Federal Register, whichever period is longer.