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Investment Management Alert

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SEC Reopens Comment Period for Its Sweeping Private Fund Proposals After Investors and Advisers Criticized Some Provisions

On February 9, 2022, the U.S. Securities and Exchange Commission (SEC) voted 3-1 to propose new rules and amendments under the U.S. Investment Advisers Act of 1940 (Advisers Act) designed to increase the regulation of private fund advisers — proposals that Commissioner Hester M. Pierce, the dissenting vote, described as a "sea change."[1] The rules are intended to "address conflicts of interest" that could reasonably lead to private fund advisers "plac[ing] their interests ahead of the private fund's interests," the commission said.

The comment period for the rules was recently extended through June 13, 2022. A number of comments to date from investors and private fund managers have raised concerns that the rules would mandate specific terms that historically have been negotiated between sophisticated investors and fund advisers, and that the rules could limit investors' options, alter private funds' investment strategies and potentially increase investors' costs.

In this article, we first outline the key provisions of the proposed rules and then summarize some of the more significant comments to date.

What the Proposed Rules Would Require

The sweeping rules are not limited to registered investment advisers. Many aspects of the proposals also apply to private fund advisers that rely on "exempt reporting adviser" exemptions promulgated by the SEC for venture capital fund advisers, foreign private advisers and smaller advisers. In addition, there are no grandfathering provisions, and so, if adopted in their current form, the proposed rules would apply to existing funds and advisers who negotiated terms with investors before the rules are adopted.[2]

For private fund advisers who are SEC-registered:

- **Quarterly Statements.** Within 45 days after each fiscal quarter, private fund advisers would need to detail information about private fund performance, fees and expenses, including fees and expenses paid by underlying portfolio investments, and any rebates

[1] Hester M. Pierce, Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking (February 9, 2022)

[2] For more details see the SEC's Fact Sheet: Private Fund Proposed Reforms and Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (full text of proposals).

or offsets that carry over to future quarters. This would allow investors to cross-reference the fees and expenses charged to the fund to the offering or organizational documents that set forth the relevant expense categories and calculation methodology.

- **Annual Audits.** The proposed rules would require an audit of each private fund advised by a private fund adviser at least annually and upon liquidation, and each audit would need to be "promptly" distributed to all of the private fund's investors. Private fund advisers would also need to cause their auditor to notify the SEC of certain events (*e.g.*, the termination of an auditor's engagement must be reported within four business days of such termination).
- **Adviser-led Secondaries.** The proposals would require private fund advisers to obtain a fairness opinion in connection with adviser-led secondaries where the private fund's investors are offered an option to sell or exchange their fund interests for interests in another vehicle sponsored by the adviser. The fairness opinion would need to be distributed prior to the transaction's closing and would need to include a written summary of any material business relationship between the private fund adviser and the independent opinion provider in the previous two years.
- **Annual Review.** The proposed rules would require SEC-registered advisers to document the annual review of their compliance policies and procedures in writing. The annual review is already required by rule 206-4(7) under the Advisers Act.
- **Books and Records.** The proposals, if adopted, would amend the Advisers Act's books and records rule to require private fund advisers to retain records related to the proposals to facilitate the SEC's ability to assess compliance with the rules.

The following provisions would apply to all private fund advisers, including private fund advisers who are not SEC-registered, such as those relying on "exempt reporting adviser" exemption:

- **Prohibited Activities.** The proposals would prohibit private fund advisers from engaging in certain activities and practices that the SEC views as "contrary to the public interest and the protection of investors." These include:
  - charging certain fees and expenses to a private fund or its portfolio investments, such as:
    - accelerated monitoring fees;
    - fees or expenses associated with an examination or investigation of the private fund adviser or its related persons by a governmental or regulatory authority;
    - regulatory or compliance fees or expenses of the private adviser or its related persons; or
    - fees and expenses related to a portfolio investment 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;
  - reducing the amount of any clawback by the amount of taxes;
  - 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; or
  - borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client.
- **Preferential Treatment/Side Letters.** The proposals would prohibit private fund advisers from providing preferential terms regarding redemptions or information about portfolio holdings or exposure to some private fund investors. The proposals would also prohibit private fund advisers from providing any other preferential terms unless those are disclosed to prospective and current investors in the private fund.

Key Comments Received

While the SEC posed specific questions for comment, given the significant impact the proposals would have on private fund advisers and their disclosure obligations, it is not surprising that the SEC has received a significant number of more general comments. Those included one from Harvey Pitt, the former chair of the SEC, questioning whether the proposals overreach by creating an unprecedented level of regulation to protect a sophisticated investor class.

While many comments critical of the proposals came from large investment advisers, industry groups and law firms that represent advisers, a number of large institutional investors and institutional investor industry groups also chimed in, querying whether the proposed rules would have unintended consequences for investors. In particular, some institutional investors and related industry groups contended that the proposed prohibitions, such as those related to preferential treatment and limitations of indemnification and exculpation, would effectively raise the standard of care so advisers could be liable based on mere "negligence."

Some institutional investors highlighted that the fiduciary duties of advisers, as reflected in the scope of indemnification and exculpation provisions, is a highly negotiated aspect of fund investment documentation. Some comments pointed out that the current market standard, "gross negligence," is the product of multiple repeat interactions between sophisticated investors and fund advisers and reflects what such investors consider to be an appropriate risk allocation between investors and advisers, as well as their expectations about the adviser's approach to investment decisions. Comment letters expressed a concern that changing to a negligence fiduciary duty standard would result not only in increased costs to investors but also possibly to diminished returns because advisers might alter their investment decision-making processes to conform to new risk allocation metric mandated by the SEC rather than the parties.

Some investors also expressed concerns about the proposed prohibition on preferential treatment, saying that that mandating disclosure of any preferential terms would erode investors' negotiating position because advisers might cease to offer preferential they do now in side letters if detailed disclosure of those terms to all investors was required. Other investors pointed out in their comments that certain preferential terms that the proposal would prohibit, such as preferential redemption rights, are frequently relied upon by investors to comply with their regulatory obligations, state laws or internal policies and, absent the ability to negotiate such a preferential treatment, their ability to invest in private funds may be limited.

Reopening the Comment Period

On May 9, 2022, the SEC reopened the comment period, extending it through June 13, 2022, and solicited additional comments from the public.