SEC Proposes Significant New Regulations for Advisors to Private Investment Funds

On February 9, 2022, the Securities and Exchange Commission ("*SEC*") published proposed regulations for investment advisers whose clients include private funds[1] (the "*Proposal*"). Among other things, the Proposal would affect the scope and timing of private fund financial reporting, prohibit certain fund terms and activities that the SEC deems contrary to investors' interests, and mandate new disclosures of preferential investor rights. As discussed below, the new rules would impact both private fund advisers that are registered under the Investment Advisers Act ("*RIAs*") and (in some cases) also private fund advisers that are exempt from registration.

The final shape of the new rules is uncertain. At least 60 days will be allowed for public comment on the Proposal, after which the SEC will consider the comments received and may release a final rule incorporating revisions based on the commentary. If the Proposal is adopted, it would mark the most significant expansion of SEC regulation over the private investment fund industry since the 2011 rule changes emerging from the Dodd-Frank Act.

The primary components of the Proposal are outlined below, along with some questions and considerations for advisers to private funds.

Going forward, private fund advisers should continue to monitor emerging SEC regulatory changes, review internal policies and procedures to ensure compliance with existing SEC rules, and take steps to ensure consistency between actual fund operations and fund governing and offering documents.

Proposed Regulations Impacting RIAs

Reporting. Within 45 days after each calendar quarter end (including year-end), RIAs would be required to distribute the information outlined below to investors of each private fund they advise. The reporting would need to be consolidated with information for similar pools of assets, such as parallel funds, feeder funds or AIVs (to the extent that would be meaningful to investors), to use clear, concise, plain English, and to be presented in a format that facilitates review from one quarterly statement to the next.

The quarterly reports would include:

a. A "Fund Table" that discloses, for each quarterly period:

   1. all fees and other compensation paid to the RIA or any of its related persons[2] by the fund, with separate line item categories, including, management fees and performance-based compensation;
   2. all other fees and expenses paid by the private fund, with separate line item categories, including organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and
   3. the amount of any management fee or similar offsets or rebates carried forward.

[1] Funds that rely on the exemption from registration in Section 3(c)(1) or 3(c)(7) of the Investment Company Act, including most private equity, venture capital, and other closed-end investment funds.

[2] "*Related persons*" include the adviser's officers, partners, directors, employees and affiliates.

b. A "Portfolio Investment Table" that discloses the following information for each covered portfolio investment[3]:

   1. all portfolio investment compensation (*e.g.*, origination, management, consulting, monitoring, or directors fees, etc.) allocated or paid to the RIA or any of its related persons by the covered portfolio investment, with separate line items for each category of allocation or payment, presented both before and after the application of any offsets, rebates, or waivers; and

   2. the fund's ownership percentage[4] and a brief description of the fund's investment in each such covered portfolio investment.

c. The following performance information as of a specified date[5]:

   1. gross IRR[6] and gross MOIC[7] for the fund;

   2. net IRR and net MOIC for the fund;

   3. gross IRR and gross MOIC for the realized and unrealized portions of the fund's portfolio, with the realized and unrealized performance shown separately; and

   4. a statement of contributions and distributions for the fund.

Performance measures must be shown from inception of the fund through the end of the applicable quarter and must be computed without the impact of any fund-level subscription facilities (including the impact of any interest payments and other expenses of any such facility).

The quarterly performance statement must include the date through which the performance information is current.

Each quarterly statement must also include "prominent disclosure" regarding (a) the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated, including cross references to the relevant sections of the private fund's organizational and offering documents, and (b) criteria used and assumptions made in calculating private fund performance.

Adviser Led Secondaries. In connection with any "continuation fund," "extension fund," or similar adviser led secondary transaction, RIAs would be required to obtain and distribute to fund investors a fairness opinion on the transaction price from an independent opinion provider (and disclose any material business relationship between the opinion provider and the RIA or its related person within the prior two years).

---

[3] A "***covered portfolio investment***" is any portfolio investment that paid portfolio investment compensation in the applicable reporting period.

[4] Which may be "zero" for funds like credit funds that do not have an ownership interest in their portfolio companies.

[5] These requirements are for "***Illiquid Funds,***" or 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. This would include most private equity, venture capital and similar closed-end investment funds.

"***Liquid Funds***" (which are any private funds other than Illiquid Funds) must instead report total net returns for the calendar year to date, average net returns for one-, five- and ten- calendar year periods, and annual total net returns for each calendar year since the fund's inception.

[6] "***Internal Rate of Return***" or "***IRR***" means the discount rate that causes the net present value of all cash flows throughout the life of the fund to be equal to zero.

[7] "***Multiple on Invested Capital***" or "***MOIC***" means as of the end of the applicable calendar quarter, the sum of (x) the unrealized value of the fund; and (y) the value of all distributions made by the fund; *divided by* the total capital contributed to the fund by its investors.

Annual Audit. RIAs would also be required to provide private fund investors with annual financial statements for the fund, prepared in accordance with U.S. GAAP[8] and audited by an independent public accountant registered with the PCAOB, "promptly" after the audit is complete. Though many RIAs already prepare audited financial statements to comply with the SEC's Custody Rule, the Proposal would go further by requiring accountants to agree to notify the SEC "promptly" after issuing any audit report with a modified opinion or within four business days after the auditor's resignation or dismissal. Additionally, for advisers who provide services to unaffiliated private funds (*e.g.*, certain sub-advisers to third-party funds), there would be an obligation to "take all reasonable steps" to cause the unaffiliated fund to undergo an audit consistent with the Proposal's rules.

Annual Compliance Review. RIAs would be required to document in writing, at least annually, the adequacy of their compliance policies and procedures, and the effectiveness of their implementation, though the Proposal leaves the scope and format of documentation to be determined by advisers based on their individual circumstances.

Key Considerations and Questions

- Will the SEC allow more flexibility on the 45 day deadline for quarterly reports? While the Proposal does allow reporting of the most recently available information if details for the current quarter are unavailable, the 45 day deadline would create operational challenges for many advisers.
- Similarly, will the SEC exempt SPVs or very small funds from some or all of the new reporting requirements that could be disproportionately burdensome for such vehicles?
- There is no ability under the Proposal to withhold information from, or modify reporting to, investors who are subject to "freedom of information" or similar public disclosure laws, which could put sensitive portfolio information at risk of disclosure.
- It is not yet clear how to account for private fund interests held on a "no fee" or "no carry" basis, like those of so-called "friends and family" funds, when calculating private fund performance under the Proposal.
- Likewise, the Proposal does not address how to treat partial realizations of investments for purposes of calculating realized versus unrealized performance figures.

Proposed Regulations Impacting All Advisers of Private Funds.

Prohibited Activities. The proposal would prohibit advisers to private funds from:

a. charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services that it does not, or does not reasonably expect to, actually provide;

b. charging the private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, or for any other regulatory or compliance fees or expenses of the adviser or its related persons;

c. reducing the amount of any carried interest or similar clawback payment by actual, potential, or hypothetical taxes;

d. seeking reimbursement, indemnification, exculpation, or limiting its liability or the liability of other covered persons for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund;

---

[8] For "*foreign private funds*" with a domicile, principal place of business or manager outside the U.S., financial statements can use a different accounting standard so long as it is substantially similar to U.S. GAAP and any material differences from U.S. GAAP are reconciled.

e. charging or allocating fees and expenses related to an actual or potential investment on a non-pro rata basis when multiple private funds and other clients participate in the same investment; and

f. borrowing or receiving credit from a private fund client.

Preferential Treatment – Prohibitions. The Proposal would prohibit any adviser to a private fund from (a) granting an investor the ability to redeem its interest or (b) providing information regarding portfolio holdings or exposures of the private fund, or of a substantially similar pool of assets, to any investor, if in either case the adviser reasonably expects that doing so would have a material, negative effect on other investors in the relevant private fund or in a substantially similar pool of assets.

Preferential Treatment – Disclosure. The Proposal would also prohibit any adviser to a private fund from providing any investor with any other preferential treatment (*e.g.*, through a side letter) unless the adviser gives each other prospective investor in the private fund written notice with specific information regarding any such preferential treatment, prior to their investment in the private fund. There would also be an obligation to update current investors in a private fund at least annually of any previously undisclosed preferential treatment granted to investors.

Key Considerations and Questions

- The SEC's proposal of an ordinary negligence standard regarding exculpation and indemnification of advisers (as opposed to the industry standard of *gross* negligence) could significantly increase litigation risk for private fund sponsors and likely result in significant insurance premium increases to advisers and private funds.
- Prohibiting the reduction of clawback payments for taxes would not only have an economic impact on private fund sponsors, but also burden them with amending previous tax returns to try recover tax payments previously made on clawed back income.
- The prohibition on preferential redemption rights may conflict with legal requirements of some investors (such as pension plans subject to ERISA) who often require redemption or withdrawal rights to avoid violations of law.

Transition Period

The Proposal currently includes a one-year compliance transition period, beginning 60 days after a final rule is published in the Federal Register. This is subject to change along with the substance of the proposed rules.

What's Next

The Proposal is open for public comment until the later of April 11, 2022 or 30 days after its publication in the Federal Register (which has yet to occur as of the date of this client alert). Given the scope of the proposed regulations and their potential impact on the entire private funds industry, we expect that sponsors, industry groups and their advisers will be very active in the comment process. Once the comment period closes, SEC staff must review the comments and prepare responses, which may include modifications to the Proposal. These responses and the final rules would be published in an adopting release, which could come later this year.

Regardless of whether the Proposal is adopted as a final rule, private fund advisers will continue to face heightened SEC scrutiny and additional regulations impacting other areas of the business. The SEC's Division of Examinations has formed the view, as evidenced in, among other instances, its recent Risk Alert, that there are deficiencies in transparency, governance, standardization and conflicts management among some private fund advisers and that this requires SEC oversight to correct. SEC Chairman Gary Gensler echoed this view in outlining his regulatory agenda for private investment funds last year.

Private fund advisers should monitor emerging SEC regulatory changes (including the Proposal), and review internal policies and procedures to ensure compliance with existing SEC rules, as well as take steps to ensure consistency between actual fund operations and terms described in offering materials and governing documents.

Choate's team is continuing to monitor developments on the Proposal. Please do not hesitate to contact us with any questions.

About the authors: Shaun Barnes is a principal in Choate's Fund Formation practice.

If you have questions regarding these developments, please contact a member of the Fund Formation team.

TEAM

Kimberly J. Kaplan-Gross
Partner
617-248-4051 | kkaplangross@choate.com

Shaun C. Barnes
Principal
617-248-5231 | sbarnes@choate.com

Gustavo Resendiz
Partner
617-248-4708 | gresendiz@choate.com

© Copyright 2022 CHOATE HALL & STEWART LLP. "CHOATE" and "Built different" are registered trademarks of Choate, Hall & Stewart LLP. Information contained herein should not be construed as legal advice or legal opinions on specific facts. The enclosed material is provided for education and information purposes by Choate, Hall & Stewart LLP to clients and others who may be interested in the subject matter.