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Legal Update

SEC Proposal Significantly Impacts Private Fund Advisers and Investors

On February 9, 2022, the US Securities and Exchange Commission (the "SEC") voted to propose a suite of new rules and amendments (the "Proposal") under the Investment Advisers Act of 1940, as amended (the "Advisers Act").[1] If adopted, the Proposal would significantly increase the compliance obligations of advisers to "private funds" and would fundamentally reorder the relative rights, liabilities and bargaining leverage between advisers and their private fund investors. The Proposal creates a more prescriptive advisory relationship, which, among other changes, would prohibit common private fund practices, such as providing exculpation and indemnification for simple negligence and net-of-tax general partner clawbacks, and would reshape side-letter practices across the private funds industry.

This Legal Update provides a more detailed analysis of the Proposal briefly summarized in our earlier Legal Update.[2]

The Proposal focuses on advisers with respect to their "private funds" (i.e., funds that would be an "investment company" but for the exceptions provided in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act")). Although the Proposal specifically refers to private equity and hedge fund sponsors, the definition of a private fund (as was the case under the Volcker Rule with the definition of "covered fund") has the broader potential to include funds that focus on infrastructure, real estate and certain securitizations (such as collateralized loan obligations ("CLOs")).

The SEC stated that the Proposal is intended to address activities harmful to private fund investors, which persist despite the SEC's examination and enforcement efforts. Specifically, the Proposal is intended to provide investors with enhanced and standardized information about fund performance, costs and preferred terms, which the SEC believes would help investors better understand marketplace dynamics, increase competition and potentially bring greater efficiencies to this sector of the capital markets. Furthermore, the Proposal aims to curb the ability of private fund advisers to act on conflicts of interests that are not transparent to investors in a manner that ultimately benefits the adviser at the expense of investors. The SEC repeatedly noted that regulation was necessary because, in the SEC's view, private funds typically lack governance mechanisms that would check adviser overreach. In the SEC's view, the common practice of delegating certain investor determinations to

limited partner advisory committees and similar conflict approval mechanisms do not go far enough to protect the interests of investors, even with informed consent.

While discrete portions of the Proposal codify current market practices, when taken as a whole, the Proposal appears to represent a departure from a regulatory approach that historically has been based on "full and fair" disclosure, informed consent and negotiations among sophisticated parties—typically high-net-worth individuals and institutional investors—toward a more protective and prescriptive regulatory framework that has some similarities to the one currently in place for registered investment funds targeted at retail investors. It also appears to be a pivot from the SEC's interpretation regarding the standard of conduct for investment advisers, which was published less than three years ago and largely memorialized the concept that an investment adviser's duty, as a fiduciary to its clients, is to "eliminate *or* make full and fair disclosure of all conflicts of interest which might incline an investment adviser . . . to render advice which is not disinterested such that a client can provide informed consent to the conflict."[3] The Proposal, in large part, instead flatly prohibits certain conflicts of interest. For example, the proposed new requirement to share broken-deal expenses *pro rata* across all participating (or potentially participating) funds and accounts stands in contrast to longstanding practice permitting a flagship fund to bear the totality of such expenses as long as proper disclosure of that practice has been provided in advance to fund investors.

If the Proposal is adopted and reshapes certain contours of the private fund industry, we expect that adviser operational costs will increase. This could lead to upward management fee pressure, thus impacting returns. The general effect of such increased costs would also make it harder for smaller firms to compete and survive, perhaps driving further consolidation in the market.

The Proposal articulates a goal of protecting those who directly or indirectly invest in private funds, noting that some of the largest groups of private fund investors include state and municipal pension plans, college and university endowments and non-profit organizations, with SEC Chair Gary Gensler indicating that the Proposal is intended to protect the "teachers, firefighters, municipal workers, students, and professors" that benefit from investments made by those institutional investors[4] and whom the SEC has recently identified as exam priorities.[5] While we expect many aspects of the Proposal may be welcomed by investors, we note that the preferential terms that the Proposal seeks to curtail are typically sought by these same institutional investors that the Proposal seeks to protect.

Practice Notes:

Which Advisers Are Affected?

Much of the Proposal is targeted solely at SEC-registered investment advisers ("RIAs") to private funds, but some aspects apply to *all* advisers to private funds, including exempt reporting advisers ("ERAs") and other advisers exempt from registration (e.g., foreign private advisers).

Competitive Advantage for Non-US Advisers?

Moreover, certain aspects of the Proposal will *not* apply to non-US-based advisers' arrangements with non-US funds. The Proposal reiterates the long-standing SEC position that the substantive provisions of the Advisers Act do not apply with respect to the non-US clients of non-US-based advisers—even if those non-US clients are funds that have US person investors.

As a result, the specific prohibitions discussed in Section B, as well as Section C below, would not apply to the non-US funds of such advisers, even if the adviser is an RIA and even if the non-US were limited solely to US investors. In contrast, the prohibitions would apply to the use of US

feeder or parallel funds by a non-US adviser, or the use of an affiliated US-based adviser as a sub-adviser.

This difference in treatment could provide non-US-based private fund managers a significant competitive advantage relative to their US counterparts, with lower costs and with greater liability protection, depending on the jurisdiction they select.

What Types of Funds Fall within the Proposal's Scope?

The Proposal primarily focuses on advisers' relationships with *private funds*, as defined. However, the Proposal doesn't include any carve-outs for—or directly acknowledge the impact on—CLOs, which frequently rely on Section 3(c)(7) under the Investment Company Act, and therefore are considered private funds.

What about Existing Funds?

The Proposal does not provide for grandfathering of existing contracts or advisory relationships.

A. Scope of Proposed Rules

The Proposal uses the term private fund as defined in the Advisers Act (i.e., an issuer that would be an investment company but for Sections 3(c)(1) or 3(c)(7) of the Investment Company Act). Several times in the Proposal, the SEC asks for comments on whether the proposed rules should also apply to other types of pooled investment vehicles, such as real estate funds that rely on a different exclusion from the definition of investment company (i.e., Section 3(c)(5)(C)) or vehicles that fall outside the definition altogether. In the event the Proposal is adopted substantially as proposed, many fund managers that currently treat their pooled investment vehicle clients as "private funds" may have a strong incentive to explore other investment company status exceptions or exemptions available to them under the Investment Company Act. Similar to the consequences of the Volcker Rule, the Proposal is likely to put pressure on investment company status analyses, both in terms of whether a particular fund is a threshold investment company or can qualify for an exception other than those provided in Section 3(c)(1) or Section 3(c)(7).

The Proposal is likely to impact CLOs differently than more traditional private funds, given the significant structural and other fundamental differences. We expect that CLO industry participants are likely to raise these concerns, as well as others, and perhaps more generally to question whether any of these changes are needed in the CLO market.

Summary Table of Proposed Rule Requirements

Proposed Rule	SEC-Registered Advisers	Advisers Not Required to Register (e.g., ERAs)	SEC-Registered Non-US Advisers with Respect to Non-US Private Funds	Exempt Non-US Advisers with Respect to Non-US Private Funds
1. Prohibited Activities (Section B of this Legal Update)	Yes	Yes	No	No
2. Preferential Treatment (Section C of this Legal Update)	Yes	Yes	No	No
3. Adviser-Led Secondaries' Opinion (Section D of this Legal Update)	Yes	No	Unclear*	No
4. Quarterly Statements (Section E of this Legal Update)	Yes	No	Unclear*	No
5. Mandatory Audit (Section F of this Legal Update)	Yes	No	Unclear*	No
6. Annual Compliance Reports (Section G of this Legal Update)	Yes	No	Yes	No

* These items would apply to SEC-registered non-US-based advisers to non-US private funds if they are deemed to not constitute "substantive prohibitions." In contrast to certain other proposed requirements, the Proposal did not make clear whether these items were "substantive."

B. Prohibited Activities

The Proposal seeks to prohibit all private fund advisers (not just RIAs) from engaging in the enumerated activities below with respect to their private fund clients and their investors, which the SEC believes are contrary to the interest of private fund investors. While we believe some of these prohibitions will be generally welcomed by investors, they represent a significant departure from the current private fund regime and will likely create new challenges for private fund advisers. Fundamentally, these prohibitions would prevent fund sponsors and investors from negotiating these terms even on a fully disclosed basis. While the Proposal notes that many of these prohibitions stem from abuses uncovered by the SEC, those abuses typically related to undisclosed practices for which the SEC already possesses significant jurisdiction and enforcement authority under existing rules, such

as Rule 206(4)-8 (which, among other things, prohibits an adviser to a private fund from committing fraud against fund investors or prospective investors, imposing a strict liability standard).

The Proposal would prohibit advisers from:

1. **Charging certain fees and expenses to a portfolio investment in respect of services that the adviser does not, or does not reasonably expect to, provide to the portfolio investment (e.g., accelerated monitoring fees).**
   Given the SEC's recent focus on fees and industry practice, we do not believe that barring "accelerated payments" will have a significant impact on private fund advisers, particularly because the Proposal would not prohibit an adviser from receiving payments in advance for services that it reasonably expects to provide to the portfolio investment in the future.

2. **Charging fees or expenses to a private fund associated with an examination or investigation of the adviser or its related persons[6] by governmental or regulatory authorities.**
   This prohibition seems to stem specifically from SEC concerns regarding a rather narrow set of circumstances where advisers have allegedly attempted to improperly cause clients to bear the cost of SEC fines and settlements.[7] Unlike item 3 below, market practice is clear on such expenses, which are, in our experience, uniformly considered adviser "overhead." We do not believe this item will cause a change in market practice.

3. **Charging fees or expenses to a private fund for any regulatory or compliance expenses or fees of the adviser or its related persons.**
   In comparison to items 1 and 2 above, this prohibition will likely be more challenging for advisers to implement. While these fees are indeed typically incurred by the adviser as "overhead," advisers will have to be more careful deciding which regulatory expenses may be borne by the fund. For instance, the Proposal notes that any expenses related to state licensing and registration requirements applicable to the adviser and its related persons (e.g., state lobbying) fall within this category; many advisers charge such expenses to the private fund and do not view them as overhead if they are a result of marketing to specific fund investors, or based on a structure necessitated by such private fund's marketing or investment activity.

Practice Notes: If this aspect of the Proposal is adopted, then arguably advisers will not be able to charge fund investors for costs related to implementing or complying with the Proposal if it is adopted.

4. **Reducing the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons or their respective owners or interest holders.**

   This aspect of the Proposal targets a very common practice related to adviser clawback provisions. In the typical private equity fund arrangement, the fund's adviser (or its affiliate) is entitled to performance-based compensation equal to a certain percentage of the profits generated by the fund, often 20 percent. If the adviser (or its affiliate) initially receives more than its negotiated amount of performance-based compensation, the fund will typically "claw back" the excess amount from the adviser. Fund governing documents typically provide that the amount clawed back from the adviser would be limited to the actual aggregate carry distributions reduced by taxes paid, or deemed paid, by the adviser (or its affiliate) and other recipients on the performance-based compensation. The Proposal would prohibit this reduction, potentially causing

carry recipients to bear the tax liability with respect to income for which they have not received (or retained) a corresponding cash distribution. Such a change, if adopted, may shift costs from investors to advisers.[8]

5. **Seeking reimbursement, indemnification, exculpation or limitation of the adviser's (and its related persons') liability to 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.**

   Perhaps most notably, this aspect of the Proposal prohibits advisers from being reimbursed, exculpated or indemnified for simple negligence and breach of fiduciary duty, and would prohibit an adviser (or fund general partner) from waiving, disclaiming or otherwise limiting any fiduciary duties under the Advisers Act or under state law—even if such a limitation is expressly permitted under state law. This would represent a significant shift in market practice, and is likely to have a disparate effect among small, mid-sized and large private fund advisers. Gross negligence is overwhelmingly used as the liability standard across US private fund documents. Simple negligence is a much lower standard that many deem inappropriate in the asset management field, where there is significant diversity in the exercise of investment discretion across the market and a complex regulatory system rife with potential foot-faults. Moreover, the investment strategy of a long-short hedge fund is different from a traditional private equity buyout fund, and the approaches to diligence and review are of necessity far different in the pursuit of such strategy.

   Breaches of fiduciary duty under state law are not always a bar to exculpation and indemnification; it is much more common to see standard carve-outs for material breaches of the fund's governing documents or a breach that has a "material adverse effect" on the fund or its business. Breaches of federal fiduciary duty have typically been subsumed under the conventional carve-outs from exculpation and indemnity for violations of the securities laws.

   In the short-term, these types of changes would likely expose advisers to increased litigation and result in higher insurance premiums—which could ultimately lead to increases in management fees or expenses borne by private funds and their investors. Over the longer-term, these types of modifications could potentially inhibit or delay the exercise of investment discretion, thus affecting the manner in which a sponsor executes the fund's strategy.

6. **Charging or allocating fees and expenses related to a portfolio investment (or 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 (or propose to invest) in the same portfolio investment.**

   The Proposal helpfully clarifies that this requirement is targeted at "broken deal" and other deal expenses, but not the ability to charge different management fees to co-investment vehicles. While many advisers aim to charge such expenses *pro rata*, it is not always practicable or supported by the deal terms. For example, private funds frequently engage in co-investments when the fund, due to various considerations (often diversification constraints or general lack of capital) is unable to partake in the entire amount of an investment offered to it. It is to the fund's (and its investors') benefit for a related entity to partake in the remainder of the investment, as it could provide the fund with a stronger voting position without a commensurate expenditure. This is why, historically, co-invest vehicles do not charge fees and carry, or charge reduced fees and carry and, accordingly, do not receive reductions for any portfolio-level compensation received by

the adviser and its related persons. Similarly, this is why many co-investors do not agree to bear broken-deal expenses. Co-investment arrangements are often highly bespoke and the one-size-fits-all rule may be unduly limiting. That said, the Proposal, on a potentially helpful note, recognizes that where a potential co-investor has not executed a "binding agreement to participate in the transaction," the Proposal would not prohibit an adviser from allocating the full amount of "broken deal" or other fees and expenses to the fund—to the extent the fund has provided adequate disclosure to investors of that practice.

7. **Borrowing money, securities or other fund assets, or receiving an extension of credit, from a private fund client.**

   It is unclear from the Proposal whether this would have the perhaps unintended effect of prohibiting a private fund from advancing indemnification expenses to the fund's adviser or its related persons.

C. Preferential Treatment

All private fund advisers (not just RIAs) would be prohibited from providing preferential terms to certain private fund investors regarding redemption rights and information regarding portfolio holdings if the adviser reasonably expects that providing the rights or information would have a "material, negative effect" on other investors. The Proposal would apply to private fund investors, as well as investors in any "substantially similar pool of assets"—i.e., a pooled investment vehicle with substantially similar investment policies, objectives or strategies to those of the private fund. Among other things, this definition would include separate feeder funds in the same master fund, parallel funds and alternative investment vehicles, and the Proposal notes that an RIA's own proprietary accounts could also be in scope of the definition.

Practice Notes:

Multi-Class Fund Structures; Consideration of "Material, Negative Effects"

In the absence of additional guidance, this aspect of the Proposal could be interpreted to prohibit multi-class fund structures with different liquidity terms, which is a common industry practice. Similarly, even without multi-class funds, it is often the case that open-end funds investing in relatively illiquid assets may require early "anchor" investors to agree to a lock-up in exchange for paying lower management fees. Because subsequent investors would have "preferential" redemption rights by comparison, these arrangements could also be interpreted to be prohibited by the Proposal.

Private fund sponsors may also face difficulties assessing whether customized reporting of portfolio holdings and exposures—which is typically requested by the types of institutional investors that the Proposal is intended to protect—will run afoul of the "material, negative effect" standard.

Potential CLO Impact

Some CLOs grant certain investors preferential redemption rights (for example, requiring such investor's consent to the CLO collateral manager's related direction). It is unclear whether such preferential rights would have the required "material negative effect" on other investors. Similarly, some CLO investors require specific portfolio information either in addition to, or organized

differently than, the information required under the related CLO indenture. It is uncommon for such information to be regarded as "material."

Advisers would also be prohibited from providing other preferential treatment unless described specifically in disclosure to current and prospective investors ahead of the investment and on an annual basis thereafter (if there are additional grants of preferential treatment in a given year). Current market practice for closed-ended funds is to provide all investors with general disclosure regarding the types of side letter terms that the RIA would agree to prior to investment, followed by providing investors with "most-favored nations" ("MFN") treatment with notice of the specific terms available to them after closing. For open-ended funds, market practice can vary, but oftentimes MFN clauses are designed to be self-executing if investors satisfy the requisite conditions.

The Proposal makes clear that, in the SEC's view, pre-investment disclosure of the mere fact that, e.g., some investors pay a lower fee does not meet the required specificity threshold; rather, advisers would be required to disclose the lower fee terms, including the applicable rate (or range of rates). The Proposal further explains that the specificity requirement could be satisfied by providing copies of side letters (with identifying information redacted) or by providing a summary of preferential terms that "specifically describes" the preferential treatment provided.

The disclosure-based regime included in this aspect of the Proposal would have a significant impact on side letter practices. As noted above, current market practice provides for general disclosure to all investors, with specific disclosure to MFN investors following the closing. A new requirement to provide specific disclosure to all investors prior to their investment could significantly increase the burden on advisers, particularly those sponsors with numerous side letters, and is likely to cause significant delays to closing. Particularly for closed-end funds, which often involve a significant number of investors coming into the fund at a single closing, this aspect of the Proposal could be read to require that each investor at the closing be provided with details of terms agreed with each other investor coming into the fund at the same closing, in addition to terms agreed to investors already in the fund.

Hedge funds typically approach the MFN process differently, often limiting MFN election rights to a specific time period (e.g., two to three years from the investor's closing), with the election period often synced to a corresponding redemption lock-up. The effect of these changes would be to significantly increase operational costs for hedge fund advisers that permit side letters.

This aspect of the Proposal could also have a significant impact on funds-of-funds that invest in other funds sponsored by the same adviser (or its related persons), because of the required pass-through requirements for distribution of the side letter disclosures. For example, if an adviser manages a fund-of-funds that invests in four other private funds advised by the same adviser (or its related persons), investors in the fund-of-funds would receive disclosure regarding all preferential terms agreed for the fund-of-fund, and all preferential terms agreed for each of the underlying funds.

Practice Notes*:*

Significant Impact on Side Letter Practices; Potential Rise in Bespoke Funds

In general, the net effect of this requirement may well be to reduce the prominence and ubiquity of side letters and further push the market toward bespoke "funds of one," which have been more

common following the elimination of the old “private adviser exemption” from investment adviser registration for advisers with 14 or fewer clients.

This may benefit larger institutional investors that are already utilizing separate accounts while limiting the variety of opportunities and products available to smaller institutional investors.

Potential CLO Impact

Some CLOs use side letters between certain investors, and the CLO collateral manager and these letter letters can include a sharing or rebating of a portion of such manager’s management fees. The letters are usually not shared with other investors, and to do so would eliminate or “chill” this customary market practice. The effect of this requirement could be substantial and could make affected investments more expensive (to maintain the economics) or lose such investments altogether, reducing capital formation.

D. Adviser-Led Secondaries

Under the Proposal, RIAs to private funds would be required to obtain a fairness opinion in adviser-led secondary transactions and to provide the opinion, along with a summary of any material business relationships between the RIA and the opinion provider (as of the past two years), to investors before the close of the transaction. The Proposal notes that while private fund investors have historically sought liquidity by selling their private fund interests on the secondary market, private fund RIAs have recently accelerated secondary or “adviser-led” transactions, which the Proposal defines as transactions initiated by the adviser or any of its related persons that offer the private fund’s investors the *choice* to: (1) sell all or a portion of their interests in the private fund; or (2) convert or exchange all or a portion of their interest in the private fund for interests in another vehicle advised by the adviser or any of its related persons. The Proposal clarified that a traditional cross trade between two advised funds would *not* be considered an adviser-led secondary transaction. Further, the Proposal indicates that a transaction would not be adviser-led if the adviser, at the unsolicited request of the investor, assists in the secondary sale of such investor’s fund interest.

The SEC stated that the goal of this aspect of the Proposal is to mitigate the conflict of interest created by the private fund adviser (and its related persons) being on both sides of the transaction and frequently receiving an economic benefit therefrom (including additional management fees and carried interest). The Proposal specifically requires private fund advisers to obtain a written opinion from an independent opinion provider stating that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair. Such opinion must be provided by an independent opinion provider which (i) provides fairness opinions in the ordinary course of business and (ii) is not a related person (as defined in Form ADV) of the adviser. The private fund adviser would also be required to prepare and distribute to private fund investors, prior to closing the transaction, a written summary of any “material business relationships” that the adviser, or its related persons, has or had within the past two years with the independent opinion provider.

Many advisers initiating secondary transactions currently obtain fairness opinions as a matter of best practice. While this portion of the Proposal will come with additional compliance costs for advisers, it appears that the market is already trending in this direction.

Practice Notes:

As defined, an adviser-led secondary transaction could potentially include the following types of transactions routinely done by advisers:

- an investor contribution of its existing fund interests for interests in another fund (e.g., an exchange or simultaneous redemption/subscription transaction);
- certain negotiated transfer/exit rights for investors, such as rights of first offer, default triggers, and "buy/sell" provisions; and
- for most CLOs, the refinancing and reset options provided under the related CLO indenture or the common "call-and-roll" transactions in which a CLO will transfer a portfolio (or portion thereof) to another CLO, usually new, that is frequently managed by the same CLO collateral manager, many of which actions are based on the CLO collateral manager's direction (often requiring a further investor direction or consent).

Potential Limit on Business Relationships

The Proposal is soliciting comments on whether private fund advisers should actually be prohibited from using an opinion provider that has served as prime broker, auditor or placement agent, or has provided investment banking services to the private fund, or the adviser or its related persons. Such a change, if adopted, would mark another departure from the historical disclosure-based regime under the Advisers Act.

Potential CLO Impact

CLOs do not currently contemplate a required fairness or other opinion (other than customary enforceability and other opinions for any implementing supplemental indenture) in connection with a refinancing or reset, and this requirement would increase costs to investors when the purpose of the opinion is economic efficiencies. Relatedly, some CLOs use an "applicable margin reset" that the SEC found did not trigger new credit risk retention requirements.[9]

E. Quarterly Statements

Currently, the Advisers Act does not require investment advisers to provide reports or statements to their advisory clients. Under the Proposal, however, RIAs to private funds would be required to provide quarterly statements to investors within 45 days of each calendar quarter end that include specified performance metrics and describe fees and expenses of the fund and its portfolio companies. The quarterly statements, which include requirements similar to Form N-1A for mutual funds, would be subject to the anti-fraud provisions of the federal securities laws and related record-keeping requirements. The proposed requirements for the quarterly statements are summarized below.

Increased transparency will likely be welcomed by investors. We note, however, that the proposed reporting requirements are expected to increase materially regulatory and compliance costs, which—subject to interpreting the Proposal's approach to compliance expenses (see above)—may not be borne by fund clients. In its discussion in the Proposal of the significant rise of private fund expenses, and its estimation of compliance burdens, the SEC did not mention the increasingly complex regulatory environment. We believe the Proposal will contribute to this trend, which could ultimately result in increased fee pressures.

The new reporting may also be of limited value to certain classes of institutional investors. Many investors, especially the state and municipal pension plans that the SEC has highlighted as requiring additional protections, have developed and negotiated highly customized reporting templates with their private fund advisers. For these investors, there may be additional costs without a correlative benefit.

We anticipate a number of significant challenges in the implementation of these reporting requirements. Illiquid funds that pursue private equity, value-add and opportunistic real estate or venture capital strategies, in particular, will likely face difficulty obtaining the necessary reporting information for their portfolio investments and estimating the unrealized portions of their portfolio. It is possible this will drive up the cost for certain assets. If the Proposal is adopted, we expect that private funds will require the underlying portfolio companies to agree to provide the required quarterly information as a condition of the fund's investment, thus layering an additional cost and negotiating hurdle at the asset level. Finally, older funds may have difficulty providing the requisite information for all periods, and the costs would tend to exacerbate end-of-term costs when the funds are proceeding toward wind-down.

We also note that many of the items for which the SEC requested comment in this section of the Proposal seemed reflective of the SEC's broader concerns with longstanding private fund compensation structures.

Practice Notes: Notably, the SEC is requesting comment about whether to totally prohibit "2 and 20" compensation arrangements, management fees based on committed capital (rather than invested capital), and the receipt of any compensation from portfolio investments. If adopted, these types of changes would have a significant impact on the private fund industry.

1. FEE AND EXPENSE DISCLOSURE

The quarterly statements would need to include a table listing the following fund-level expenses: (1) a detailed accounting of all compensation, fees and other amounts allocated or paid to the adviser or its related persons by the private fund during the reporting period; (2) a detailed accounting of all other fees and expenses paid by the private fund during the reporting period; and (3) the amount of any unapplied offsets or rebates carried forward during the reporting period to subsequent quarterly periods. It is important to note that the Proposal specifically indicates that with respect to private fund expenses, it would not be sufficient to report a single line item for "fund expenses." Instead, advisers would need to include a breakdown of, for instance, insurance premiums, administrator fees, audit fees, etc. during the reporting period. The Proposal also notes that where a private fund has agreed to compensate an adviser or its affiliates for certain additional services (e.g., consulting, legal or back-office), that compensation would need to be disclosed as adviser compensation rather than as fund expenses.

The SEC explained that these requirements are designed to enable private fund investors to better understand the magnitude and scope of fund-level expenses, which they noted have recently expanded significantly, and ensure that such compensation is made in accordance with contractual arrangements.

In addition, RIAs to private funds would need to disclose: (1) a detailed accounting of all portfolio investment compensation allocated or paid by a portfolio investment during the reporting period;

and (2) the private fund's ownership percentage of each such portfolio investment as of the end of the reporting period.[10]

Similar to the proposed private fund-level disclosure, this new table is intended to improve transparency for investors and also highlight potential conflicts of interest of the adviser and its related persons.

2. PERFORMANCE DISCLOSURE

The Proposal also requires quarterly statements to include standardized fund performance information. The rule includes different metrics for "liquid funds" and "illiquid funds" but is generally intended to enable investors to compare their various private fund investments to determine what to do holistically with their overall investment portfolio. We note that the definition of illiquid fund is a new definition and does not rely on pre-existing definitions in Form ADV, Form PF or the Volcker Rule.

The Proposal defines an "illiquid fund" 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. A "liquid fund" is defined as any private fund that is not an illiquid fund. The Proposal recognizes that there would be circumstances where a private fund may not neatly fit into the liquid or illiquid designations, although given the conjunctive construction of the "illiquid fund" definition, it seems likely that the "liquid fund" category may be over-inclusive.

RIAs to liquid funds would need to disclose the following information: (1) the fund's annual net total returns for each calendar year since inception; (2) the fund's annual net total returns over the one-, five-, and 10-calendar year periods, as applicable; and (3) the fund's cumulative net total return for the current calendar year as of the most recent calendar quarter covered by the quarterly statement.

RIAs to illiquid funds would need to provide investors with a statement of contributions and distributions for the fund and disclose the following performance measures, shown since inception of the fund and computed without the impact of any fund-level subscription facilities: (1) gross internal rate of return and gross multiple of invested capital; (2) net internal rate of return and net multiple of invested capital; and (3) gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.[11] The Proposal's requirement to present performance information without the impact of fund-level subscription facilities is consistent with the SEC staff's long-standing concern that the use of these facilities, without proper disclosure, can artificially inflate the internal rates of return reported to fund investors. The Proposal acknowledges that this requirement will require advisers to make certain assumptions regarding when capital would have been called if the facility had not been used, and also to back out fees and expenses associated with the use of a facility, such as interest expenses, when presenting performance figures.

The Proposal notes that while advisers would be permitted to include other performance metrics in the quarterly statements, the SEC cautioned that additional disclosure might be subject to other rules and regulations, such as the recently amended Advisers Act marketing rule (Rule 206(4)-1).[12]

Practice Notes:

Low-Hanging Fruit for Examinations and Enforcement Actions

This portion of the Proposal is subject to a strict liability standard. Given the Proposal's specific requirements with respect to content and formatting, we expect the SEC will be looking for technical violations of the reporting requirements if they are adopted.

Potential CLO Impact

We expect that both CLO sponsors and investors will be opposed to this portion of the Proposal. In our experience, CLO noteholders typically are not concerned with the types of performance metrics and expense reporting regime embodied in this aspect of the Proposal, resulting in little (if any) value from these new reports. Moreover, given that most CLOs make use of a trust structure with an independent trustee that is responsible for implementing the CLO's waterfall mechanics, CLOs generally do not present the same types of concerns that the SEC raised in the Proposal regarding private fund advisers incorrectly calculating and charging fees.

F. Mandatory Private Fund Audits

Under the Proposal, RIAs to private funds would be required to obtain annual financial audits of such private funds from an independent public accountant prepared in accordance with US generally accepted accounting principles and "promptly" distribute such audited statements to investors following the completion of the audit. Many private fund advisers already do this pursuant to the custody rule under the Advisers Act (Rule 206(4)-2) or pursuant to side letters with institutional investors. However, the timing requirement for delivery in the Proposal is more permissive than under the custody rule. The SEC considered requiring distribution of the audited financial statements within 120 days of a private fund's fiscal year end, consistent with the custody rule. However, the Proposal notes that reliance on third parties and circumstances such as the COVID-19 pandemic may cause an adviser to fail to meet the 120-day timeframe.

The other significant departure from the custody rule is that the Proposal would also require the auditor performing the audit to enter into a written agreement with the adviser or the private fund pursuant to which the auditor would be required to promptly notify the SEC's Division of Examinations upon the auditor's resignation, dismissal or other termination (within four business days) or issuance of a modified opinion (i.e., a qualified opinion, an adverse opinion or a disclaimer of opinion). The Proposal notes that similar information is provided to the SEC from accountants who perform surprise examinations under the custody rule (where, unlike under the Proposal, advisers can elect to undergo surprise examinations in lieu of annual audits) and the timely receipt of such information has enabled the SEC to identify harmful misconduct and other compliance issues. The Proposal also contains an exception for advisers (likely sub-advisers) who do not control (and are not under common control with) the private fund, where the adviser takes all reasonable steps to cause an audit but is unsuccessful.

It is unclear whether the SEC staff's guidance regarding fund audits under the custody rule will be incorporated in any final adoption, including with respect to the treatment of special purpose vehicles ("SPVs") that hold investments below a fund and may technically also be "private funds" because they rely on the relevant Investment Company Act exceptions. We believe that requiring audited financial statements to be prepared and distributed regarding these SPVs—which is generally not required

under applicable custody rule guidance—would be unlikely to serve the SEC's goals, and would almost certainly increase costs for fund investors.[13]

Practice Notes:

Impact on SPVs

RIAs may be required to get audited financial statements for SPVs that hold investments below the fund.

Potential CLO Impact

This portion of the Proposal will be materially burdensome, and, in our view, of only limited utility, for CLOs. Given their trust structures that largely eliminate collateral manager access to CLO assets, most CLOs are not subject to the custody rule, and accordingly are not currently required to either undergo a surprise examination or distribute annual audited financial statements since these are rarely required in CLO transactions. Accordingly, requiring the production and distribution of annual audited financial statements for CLOs would represent a wholly new cost for these funds, seemingly without any incremental benefit for CLO investors.

G. Written Documentation of Annual Review of Compliance Programs

Lastly, the Proposal would amend Rule 206(4)-7 to require all RIAs to document the annual review of their compliance policies and procedures in writing. Although written reports for these reviews are somewhat common, they are not currently required by the rule. In explaining these changes, the Proposal also sets out the SEC's position that claims of attorney-client privilege, work-product doctrine and other similar protections over required records (including with respect to reviews and work prepared by compliance consultants engaged by outside counsel) are inconsistent with an RIA's obligations to produce documents promptly to the SEC and the staff's ability to conduct examinations.

As summarized above, the Proposal would impose significant new requirements on private fund advisers. If adopted, investment advisers to private funds—registered and unregistered alike—will need to reconsider private fund agreements and side letters, while private fund RIAs will also need to make significant modifications to their private fund investor reporting and disclosures, as well as compliance policies and procedures. The Proposal currently provides for only a one-year compliance period, with no provision for grandfathering existing funds and arrangements.

Given the potential for the Proposal to reshape the private fund market, we fully expect that all sectors of the private fund industry will engage with the SEC during the comment period. The comment period for the Proposal is open to the public until the later of April 11, 2022, and 30 days after publication in the *Federal Register*.

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Endnotes

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 5955 (Feb. 9, 2022) (Release), *available at* https://www.sec.gov/rules/proposed/2022/ia-5955.pdf.

[2] SEC Proposals Would Significantly Impact Private Fund Advisers and Impose New Cybersecurity Requirements on Registered Advisers and Funds, including BDCs (February 14, 2022), *available at* https://www.mayerbrown.com/en/perspectives-events/publications/2022/02/sec-proposals-would-significantly-impact-private-fund-advisers-and-impose-new-cybersecurity-requirements-on-registered-advisers-and-funds-including-bdcs

[3] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. 1A-5248, at n. 24 and accompanying text, (July 12, 2019) (Release), *available at* https://www.sec.gov/rules/interp/2019/ia-5248.pdf. According to the SEC, the Fiduciary Interpretation was intended to "reaffirm—and in some cases clarify—certain aspects of the fiduciary duty," affirming that this disclosure-based posture reflected long-standing practices and guidance. *Id.* at n.7 and accompanying text.

[4] Statement on Private Fund Advisers Proposal, (February 9, 2022), *available at* https://www.sec.gov/news/statement/gensler-statement-private-fund-advisers-proposal-020922.

[5] *See, e.g.*, 2021 SEC Examination Priorities, *available at* https://www.sec.gov/files/2021-exam-priorities.pdf.

[6] The Proposal uses the same definition of "related person" as Form ADV.

[7] *See, e.g.*, SEC Litigation Release No. 23188 (Feb. 5, 2015), *available at* https://www.sec.gov/litigation/litreleases/2015/lr23188.htm.

[8] For an in-depth analysis of this proposed prohibition, please see our prior Legal Update, Proposed SEC Rule Change Would Eliminate After-Tax Clawbacks in Private Funds (February 18, 2022), *available at* https://www.mayerbrown.com/en/perspectives-events/publications/2022/02/proposed-sec-rule-change-would-eliminate-after-tax-clawbacks-in-private-funds

[9] *See* Sancus Capital, SEC Staff No-Action Letter (Sept. 1, 2016), *available at* https://www.sec.gov/divisions/corpfin/cf-noaction/2016/sancus090116-reg-rr.htm.

[10] The term "portfolio investment" is intended to capture any entity or issuer in which the private fund holds an investment including through holding companies, subsidiaries and other intermediary vehicles, and will often require advisers to make a good faith determination of which entity or entities constitute the "portfolio investment."

[11] Notably, the Release acknowledged that separately calculating *net* figures for realized and unrealized investments "could involve complex and potentially subjective assumptions regarding the allocation of fund-level fees, expenses, and adviser compensation between the realized and unrealized portions of the portfolio …. [which] would likely diminish the benefits net performance measures would provide." Private Fund Advisers Release *supra* note 1 at n.93 and accompanying text.

[12] Please see our prior Legal Update, *available at* https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2021/02/new-advisers-act-marketing-rulev2.pdf

[13] *See generally* IM Guidance Update, No. 2014-07 (June 2014), *available at* https://www.sec.gov/investment/im-guidance-2014-07.pdf

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