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April 1, 2022

VIA E-MAIL

To Our Investment Adviser Clients and Other Friends

Re: SEC Proposes Fundamental Changes to Private Fund Regulation

The U.S. Securities and Exchange Commission (the "SEC") recently proposed extensive new rules and amendments under the Investment Advisers Act of 1940 (the "Advisers Act") that mandate new regulations for investment advisers to "private funds," including some that apply to advisers not registered with the SEC such as exempt private fund advisers and state-registered advisers.[1] The SEC's rationale for the proposed changes is to increase transparency, efficiency and internal governance mechanisms for private fund advisers, who have a large impact on the economy through the funds they manage. A brief overview of the proposed rules and amendments is provided below.

Some of the proposed rules, particularly the rules regarding prohibited activities and preferential treatment discussed below, present a dramatic departure from the position taken historically by the SEC, which refrained from flat prohibitions in favor of meaningful disclosure.[2] In addition, it is unclear how the proposed rules would affect existing contracts and arrangements between advisers and investors.

The proposed rules are now open for comment until April 25, 2022. We typically do not provide in-depth summaries on rule proposals (as opposed to final rules) but we believe all industry participants should be aware of the far-reaching nature of this proposal and encourage you to take advantage of the comment period to provide your own perspectives. The SEC has proposed that compliance with the proposed rules would begin on May 25, 2023.

Prohibited Activities. The proposed rules would prohibit an investment adviser to a private fund from engaging, directly or indirectly, in certain activities with respect to the private fund or its investors and portfolio investments. These prohibitions would apply to all private fund advisers, including advisers that are not registered with the SEC, such as exempt reporting advisers and state-registered investment advisers. Some of these prohibitions, such as the prohibiting an adviser from receiving indemnification for negligent activities, would significantly alter the economic relationship between the adviser and the fund.

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[1] *See* https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf

[2] *See*, for example, the 2019 Commission Interpretation Regarding Standard of Conduct for Investment Advisers, available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

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Indemnification and Limitations on Liability. The proposed rules would prohibit an adviser to a private fund from 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 fund. The SEC noted that the organizational documents of many private funds contain such provisions and, in the SEC's view, such provisions have become more aggressive. The SEC stated that such provisions are not in the public interest or consistent with the protection of investors.

The proposed rules would significantly expand the potential liability of an adviser to include negligence, rather than limiting the adviser's liability to gross negligence. The SEC requested comment on whether the prohibition should apply only to gross negligence, rather than mere negligence. It also requested comment regarding whether the proposed rules would increase operating expenses for advisers.

Regulatory Compliance and Examination Expenses. The proposed rules would prohibit an investment adviser from charging a private fund for regulatory or compliance fees or expenses of the investment adviser and its related persons. The proposed rules also would prohibit an investment adviser from charging a private fund for the fees and expenses associated with an examination or investigation of the adviser and its related persons by any governmental or regulatory authority. This prohibition would apply even if the adviser does not charge the private fund management fees, but instead requires the private fund to pay the adviser's overhead and operating expenses. The SEC requested comment regarding whether an adviser should be permitted to charge these fees and expenses to a private fund if the practice was fully disclosed and consented to by the private fund's investors or advisory committee.

The rule would not prohibit an adviser from charging a private fund for regulatory, compliance and similar fees and expenses that directly relate to the fund (such as costs incurred in connection with filing a Form D under Regulation D). If it is not clear whether a fee or expense relates to the fund or the adviser, the adviser would be required to allocate such fee or expense in a manner that it believes in good faith is fair and equitable and consistent with its fiduciary duty.

Reducing Clawbacks for Taxes. The proposed rules would prohibit an adviser from reducing the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons or their respective owners. An adviser clawback means an obligation of the adviser, its related persons or their owners to restore or otherwise return performance-based compensation to the private fund. This can arise in private equity funds that permit an adviser to receive carried interest distributions on a deal-by-deal basis (a so-called "American-style waterfall"). The SEC has requested comment on whether the SEC should instead prohibit American-style waterfalls.

Non-Pro Rata Fee and Expense Allocation. The proposed rules would prohibit an adviser from allocating fees and expenses relating to an existing or potential portfolio investment among its private funds and other clients on a non-pro rata basis if more than one private fund or other client participate in that investment. This could arise, for example, when an adviser offers investors in a private fund or other persons the option to co-invest in a portfolio investment with

the fund, or when the adviser organizes a vehicle to facilitate such co-investments. The proposed rules do not define "pro rata" for purposes of allocating expenses, and it does not address how expenses should be allocated between private funds and other investors if they invest at different times. The SEC requested comment on both of these issues. The SEC also asked for comments regarding whether there are any circumstances where non-pro rata allocations of fees and expenses should be permitted.

The prohibition would apply to expenses incurred in connection with prospective investments that are not consummated ("broken deal" expenses). The SEC noted that such expenses are often allocated to one or more of the adviser's private funds that would have participated in the investment, and not to other co-investors. The proposed rule would prohibit the adviser from making allocating such expenses only to the private funds. However, if a potential co-investor has not executed a binding agreement to participate in an investment, the proposed rule would permit the adviser to allocate that potential co-investor's share of any broken deal expenses instead to a fund that would have participated in that transaction, although the staff cautioned that an adviser may be liable under the antifraud provisions of the federal securities laws if the fund's offering and organizational documents do not authorize such allocations. The SEC asked for comments regarding whether the prohibition on non-pro rata allocations should apply to transactions that are not consummated.

Borrowing. The proposed rule would prohibit an adviser from directly or indirectly borrowing money, securities or other assets, or receiving a loan or extension of credit, from a private fund client. The rule would not prohibit an adviser from making loans to a private fund client or causing a private fund to borrow money from a third party. The rule would potentially prohibit an adviser from receiving advances or distributions from a private fund client to permit the adviser or its beneficial owners to pay their taxes arising from the adviser's interest in the fund. The SEC requested comment regarding whether the rule should carve out such advances and distributions.

Accelerated Payments. The proposed rules would prohibit an investment adviser from charging a portfolio investment of the private fund fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment. This could arise, for example, where an adviser enters into an agreement to provide consulting services to a portfolio company and the agreement provides for the acceleration of those fees on the occurrence of certain events, such as a sale of the company (sometimes referred to as "accelerated payments"). The rule would prohibit such arrangements.

The rule would not prohibit an adviser from charging a portfolio investment in advance for services that the adviser reasonably expects to perform, although the adviser would be required to refund any prepaid amounts attributable to any services the adviser does not provide. In addition, the rule would not prohibit arrangements where all of the economic benefit of any accelerated payments is shifted to the private fund's investors, such as by way of a management fee offset or rebate.

Preferential Treatment. In a marked departure from the SEC's historical emphasis on disclosure, the proposed rules prohibit all fund advisers, whether registered with the SEC or a

state, or exempt from registration, from providing preferential liquidity or transparency rights to some investors if the adviser reasonably expects those rights will have a "material negative effect" on other investors in the fund or a substantially similar pool of assets. Other terms will be prohibited unless the adviser provides adequate disclosure to other investors.

The SEC acknowledged that preferential treatment (for example, as set forth in "side letters") may benefit the fund and other investors. The SEC expressed skepticism, however, about the extent of those benefits. The SEC stated, "While the fund may also experience some benefits, including the ability to attract additional investors and to spread expenses over a broader investor and asset base, there are scenarios where the preferential liquidity terms harm the fund and other investors." As a result, the SEC believes that potential harms to other investors justify restricting these types of preferential treatment.

The proposed rules also prohibit an adviser from providing information regarding the portfolio holdings or exposures of a fund or of a substantially similar pool of assets if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in the private fund or substantially similar pool of assets. The SEC noted that preferential transparency can allow the side letter investor to front run the fund or otherwise disadvantage other investors. The SEC asserts that advisers tend to provide the preferential information rights in exchange for something of benefit to the adviser (not the fund or other investors). Accordingly, the proposed rule is designed to neutralize this potential for advisers to treat portfolio holdings information as a commodity to be used to gain or maintain favor with certain investors. Again, the SEC believes prohibiting this preferential treatment would curtail activity that harms investors.

Other preferential terms would be prohibited unless the adviser provides certain written disclosures to prospective and current investors. For example, an adviser might provide one investor "excuse" rights to avoid participating in certain investments. The SEC also would expect advisers to disclose preferential fees provided to certain investors. The SEC asserts that this disclosure would enable investors to understand better certain potential conflicts of interest and the risk of potential harms or other disadvantages. Advisers would need to describe the preferential treatment specifically to convey its relevance. For example, if an adviser gives an investor better fees in exchange for a larger investment, the disclosure would need to describe the lower fee terms, including the applicable rate, to provide the specific information required by the rule (i.e., the adviser could not simply disclose that another investor pays lower fees). Timing of disclosure would differ for prospective and existing investors. For prospective investors, the notice would need to be provided in writing prior to investment. For existing investors, the adviser would need to distribute a notice annually if any preferential treatment is provided to an investor since the last notice.

The SEC is soliciting comments on specific aspects of the proposed rule. Among these specific requests, the SEC asks if it should prohibit *all* preferential treatment. The SEC also asks whether the proposed rule should apply to terms an advisor reasonably *could* have a material negative effect (not just *would*). The SEC also asks if it should prohibit *all* preferential liquidity terms or preferential transparency regarding holdings or exposures, not just those expected to have a material negative effect on other investors. The SEC asks if it should restrict the use of

side letters and side arrangements generally, so they can only be used to address certain matters, like legal, regulatory or tax issues specific to an investor. The specific requests for comment suggest that the SEC is willing to stretch its regulatory reach to prohibit what to date have been common and widely used arrangements between advisers and strategic or early investors.

Quarterly Statements. The proposed rule would require SEC-registered advisers to distribute a highly detailed quarterly statement to investors in private funds within 45 days after each calendar quarter-end. The quarterly statement would be required to contain:

- *Fund Table.* A "Fund Table" showing fees and expenses incurred or paid by the fund during the reporting period, with separate line items for (a) all compensation, fees and other amounts, such as performance-based compensation (each reported separately), (b) all other fees and expenses paid by the fund (broken down further into detailed categories, including, but not limited to, organizational, accounting, legal, administrative audit, tax due diligence and travel), and (c) any offsets or rebates carried forward to future periods to reduce future payments to the adviser or its related persons.

- *Portfolio Investment Table.* A "Portfolio Investment Table" showing all fees and expenses (such as director compensation or monitoring fees) paid by the fund's portfolio investments to the adviser and any of its related persons, and the fund's ownership percentage of each such portfolio investment.

- *Methodology.* Prominent disclosure regarding the manner in which the information in the Fund Table and Performance Table is calculated, with cross-references to the relevant sections of the fund's governing documents that set forth the applicable methodologies. For example, the statement would be required to describe the structure of a fund's distribution waterfall and the basis on which management fees are calculated. According to the proposal, this information would assist investors in "understanding and evaluating" the adviser's calculations. Instead, we believe this information will add pages of repetitive disclosures (as the operative provisions are already in the fund's governing documents and offering materials).

- *Standardized Performance Information.* Standardized fund performance information, based on either:

    - (a) For "liquid" funds, the fund's "net total return" (which is not defined) on an annual basis since the fund's inception, average annual net total returns over 1, 5 and 10 calendar year periods, and cumulative net total returns for the current year (as of the end of the most recent quarter) and on a quarterly basis for the current year; or

    - (b) For "illiquid" funds, the internal rate of return ("IRR") and a net multiple of invested capital ("MOIC"), on a gross and net basis, through the end of the calendar quarter of the report. IRR and MOIC would be

specifically defined to limit deviations. The performance presentation would also need to detail all contributions and distributions for the fund and separately report the gross IRR and gross MOIC for the realized portion and unrealized portion of the fund's portfolio.

The Release acknowledges the difficulty in categorizing "hybrid" funds (such as side pocket funds) into these categories but would require managers to apply a facts and circumstances test to classify each fund as "liquid" or "illiquid" and report performance accordingly. The Release also requests comment on the challenges associated with comparing fund-level returns across funds with (a) widely varying levels of internal capital that typically is not subject to fees and (b) different fee classes with different management and performance-based compensation rates.

The Release acknowledges that "some" investors receive annual performance information "if" that fund is audited, but states that investors would benefit from standardized and more frequent performance reports than available through annual audited financials. In our experience, nearly every private fund managed by an SEC-registered adviser undergoes an annual audit. Nevertheless, the SEC staff appears to believe that the fee and expense details provided in audited annual financial statements are insufficient (although the release does not specifically compare the level of detail required in audited financial statements prepared under GAAP to the details proposed).

The SEC requested comments on many technical details of the quarterly statements, which highlights the compliance challenges that advisers would face in both the implementation phase as well as ongoing annual reporting. The SEC estimated the direct costs of complying with these provisions to be over $300 million per year, which the SEC acknowledges may be borne by the funds' investors if permissible under the funds' governing documents.

Beyond simply requesting comments on the technical details of the proposals, the SEC also requested comment on whether advisers should be prohibited from following widely-adopted compensation practices, such as management fees exceeding 2% per year, performance-based fees, allocations or carried interest in excess of 20%, and management fees based on committed capital. We expect an industry uproar over that suggestion, which disregards (a) the business justification for these types of arrangements, (b) the disruptions to existing fund-level and management company-level economic arrangements for nearly all private equity, venture capital, hedge fund and other private funds and fund managers and (c) the longstanding regulatory principle that private funds that accept only sophisticated investors such as accredited investors or qualified purchasers should have significantly more regulatory flexibility.

Audit Rule. The proposed rules would require SEC-registered advisers to have the financial statements for each private fund they managed audited each year and on liquidation of the fund. The SEC indicated in the Release that although audits have traditionally been used to verify the existence of fund investments, the proposed rule is also aimed at reducing the risk of advisers inflating the value of their funds' assets to increase their compensation or artificially boost their performance.

As noted above, nearly all private funds already undergo an annual audit. Most registered advisers take advantage of the annual audit alternative to the annual surprise examination requirement under the custody rule in the Advisers Act. Moreover, audited financials are an industry standard that most sophisticated investors expect. The proposed rules would thus make mandatory what is already widely practiced. Although modelled after the custody rule, they would operate independently of it, and compliance with one would not automatically satisfy the requirements of the other. Advisers who currently are not required to have their funds' financial statements audited under the custody rule would be required to obtain audits under the proposed rules. The SEC noted in the Release that audits include assessments of the fair value estimates of fund assets; thus they protect against improper valuations in a way that surprise examinations do not.

The proposed rules' most significant addition to the custody rule's audit provisions is the requirement that the adviser or the private fund enter into an agreement with the auditor that obligates the auditor to notify the SEC's Division of Examinations (i) within four business days if the auditor resigns, is dismissed or otherwise terminated, or removes itself from consideration from being reappointed, and (ii) promptly if its audit report includes a modified opinion.

The auditing standards for the financial statements and the auditor qualifications set out in the proposed rules are the same as those of the custody rule. The audit must meet the definition of "audit" in rule 1-02(d) of Regulation S-X. The audited statements must be prepared in accordance with U.S. GAAP or, for non-U.S. funds or funds with a non-U.S. manager or general partner, a substantially similar non-U.S. accounting methodology, with material differences from U.S. GAAP reconciled. The auditor must be an independent public accountant registered with and subject to inspection by the PCAOB and meet the independence standards in rule 2-01(b) and (c) of Regulation S-X.

Advisers would be required to distribute their funds' audited financial statements to their investors promptly. The proposed rules do not define "promptly" but the SEC stated in the Release that 120 days after fiscal year-end -- the same as is required under the custody rule -- would be a "generally appropriate" period. The SEC acknowledged that special circumstances, such as funds of funds' reliance on third party audits or logistical disruptions like those experienced during the COVID pandemic, may prohibit advisers from meeting a fixed deadline.

Subadvisers to funds they do not control would only be required to take reasonable steps to ensure that those funds undergo audits that satisfies the elements of the proposed rules.

Consistent with the custody rule's audit provisions, the proposed rules would not allow a newly formed fund or a fund in liquidation to incorporate the initial or final "stub period" into the first or final audit, on the grounds that material misstatements are more likely to cause irreparable harm to investors the longer they go undiscovered. A separate audit would be required for any initial or final partial year. The SEC acknowledged in the Release that a fund in the process of liquidating will likely have few transactions and few holdings but still declined to permit audits less than annually during that period. It stated that requiring audits less than annually during liquidation would not result in any meaningful cost savings to adviser or investors. Advisers may challenge this assertion, and perhaps anticipating that, the SEC is

requesting comment on whether stub period audits and annual audits for funds in liquidation should be required or whether there are other effective ways to protect investors during those periods.

The SEC is also requesting comments on many other issues raised by the proposed audit rules, including whether compliance with the custody rule should be deemed to satisfy the audit rule requirements; whether an exception should be made for advisers who play no role in valuing their funds' assets; whether exceptions should be made for small funds, funds with few investors, or funds whose investors are all related persons of the adviser; and whether the proposed rules should also apply to exempt reporting advisers.

Adviser-Led Secondaries. The proposed rules require SEC-registered private fund advisers to obtain a fairness opinion in connection with some adviser-led secondary transactions in private fund interests. Adviser-led secondary transaction means any transaction initiated by the investment adviser or any of its related persons that offers private fund investors the choice to: (a) sell all or a portion of their interests in the private fund; or (b) 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. This definition is quite broad and would pick up, among other things, transactions in which a fund manager offers investors in one fund the option to exchange their assets in that fund for an interest in a new fund, or to receive a cash payment for those assests.

The proposed rules prohibit such adviser-led secondary transactions without first distributing a fairness opinion from an independent provider and a summary of any material business relationships of the independent opinion provider has or has had within the last two years with the adviser or any of its related persons.

These significant proposals will impact all investment advisers to private funds, not just those registered with the SEC, and the proposals represent a significant change to the existing regulatory framework. Please contact us if you have any questions regarding these proposed rules.

In addition to the above proposed rules for both registered and unregistered private fund advisers, the SEC has recently proposed several other extensive rule amendments that would impact all investment advisers, including a proposed amendment to require all registered investment advisers to document in writing the annual review of the compliance policies and procedures and proposals increasing Form PF reporting requirements, requiring written cybersecurity procedures and reporting to the SEC significant cybersecurity incidents affecting the adviser, its separate account clients or private fund investors, and increasing and accelerating the reporting required under Section 13 of the Securities Exchange Act of 1934, as amended.

This letter is not intended as specific or complete advice and is subject to change. For further assistance, please contact one of the attorneys in the Investment Funds & Advisers group at Shartsis: John Broadhurst, Carolyn Reiser, Neil Koren, Jim Frolik, Christina Hamilton, David Suozzi, Anthony Caldwell, Jahan Raissi, Kevin Leiske, or Joan Grant.

Previous letters to our investment advisory clients and friends and additional discussions of topics relevant to private fund managers, investment advisers and private investment funds can be found at our insights page: www.sflaw.com/blog/investment-funds-advisers-insights.

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