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Alert

SEC Proposes New Rules for Private Fund Managers

February 10, 2022

On Feb. 9, 2022 the Securities and Exchange Commission ("SEC") proposed a series of new rules, and amendments to existing rules, (the "Proposed Rules")[1] under the Investment Advisers Act of 1940 (the "Advisers Act") applicable to private fund managers. The Proposed Rules seek to, among other things: (i) require specified and standardized quarterly disclosures regarding performance, fees and expenses, (ii) prohibit private fund managers from engaging in certain activities, (iii) require disclosure of, and in some cases limit, preferential treatment provided to certain private fund investors, (iv) require that all private funds be subject to annual audit, (v) add a written documentation requirement for annual reviews and (vi) create requirements to keep records of compliance with the Proposed Rules. Certain of the Proposed Rules apply only to SEC-registered investment advisers to private funds ("Registered Advisers") and others apply to all investment advisers to private funds ("Private Fund Advisers"), even when such Private Fund Advisers are not SEC-registered.

Quarterly Statements Rule. The Proposed Rules would require Registered Advisers to distribute to investors a quarterly statement for each private fund within 45 days of the end of the calendar quarter. These statements must include the following items relating to the private fund for the applicable reporting period:[2]

- A detailed accounting of all compensation, fees and other amounts allocated or paid to the Registered Adviser or any of its related persons, with separate line items for each category of allocation or payment (e.g., management, sub-advisory, performance-based compensation, similar fees or payments);
- A detailed accounting of all fees and expenses paid during the reporting period, with separate line items for each category of expense (e.g., organizational, accounting, legal, administration, audit, tax, due diligence, travel);
- For each portfolio investment that paid the Registered Adviser or its related persons compensation during that quarter, a detailed accounting of such compensation and the fund's ownership percentage of the applicable portfolio investment;

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

[2] The "reporting period" is generally the private fund's calendar quarter, however the initial quarterly statement for newly-formed private funds covers the first two full calendar quarters of operating results. In addition to providing the specific disclosures identified in the Proposed Rules, private fund managers would also be required to (i) consolidate reporting for "substantially similar pools of assets" if doing so would provide more meaningful information to investors, (ii) prepare quarterly statements using plain English and in a format that facilitates review from one quarter to the next and (iii) include prominent disclosures of the criteria used and assumptions made in calculating performance.

- Prominent disclosures of the calculation methodologies for all expenses, payments, allocations, rebates, waivers and offsets, including cross-references to the private fund's organizational and offering documents; and
- performance information that is calculated using methodologies specified in the Proposed Rule, with the required performance metrics different for "liquid" vs "illiquid" funds.

Prohibited Activities Rule. The Proposed Rules prohibit all Private Fund Advisers (including advisers not registered with the SEC) from engaging in certain specified activities. These prohibitions would apply regardless of whether the private fund's governing documents permit such activities, including when investors have given explicit or implicit consent to such activities. Private Fund Advisers would be prohibited from, with respect to a private fund or any investor in a private fund:

- Seeking reimbursement, indemnification, exculpation, or limitation of the Private Fund Adviser's 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;
- Charging the private fund for fees or expenses associated with (i) an examination or investigation of the Private Fund Adviser or its related persons by any governmental or regulatory authority, or (ii) regulatory or compliance fees or expenses of the Private Fund Adviser or its related persons;
- Reducing the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the Private Fund Adviser, its related persons or their respective owners or interest holders;
- 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 Private Fund Adviser or its related persons have invested (or propose to invest) in the same portfolio investment;
- Charging a portfolio investment for monitoring, servicing, consulting or other fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment; and
- Borrowing money, securities or other private fund assets, or receive a loan or an extension of credit, from a private fund client.

Preferential Treatment Rule. The Proposed Rules would prohibit all Private Fund Advisers (including advisers not registered with the SEC) from giving certain forms of preferential treatment to investors in a private fund, and would require disclosure of all other kinds of preferential treatment given to investors. Private Fund Advisers would be prohibited from:

- Granting an investor in a private fund or a "substantially similar pool of assets"[3] the ability to redeem its interest on terms that the Private Fund Adviser reasonably expects to have a material, negative effect on other investors in that private fund or substantially similar pool of assets and

[3] The Proposed Rules define "substantially similar pool of assets" as a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser or its related persons.

- Providing information regarding the portfolio holdings or exposures of a private fund, or of a substantially similar pool of assets, if the Private Fund Adviser reasonably expects that providing that information would have a material, negative effect on other investors in that private fund.

The Proposed Rules would also require Private Fund Advisers to specifically disclose all other preferential treatment given to an investor in a private fund to all prospective and current investors in that fund. These written disclosures must be provided to prospective investors in writing prior to their investment, and an annual notice describing preferential treatment given would need to be provided to all existing investors.

Private Fund Audit Rule. The Proposed Rules would require Registered Advisers to obtain a financial statement audit from an independent public accountant for each private fund they advise at least annually and upon liquidation. Although an annual audit conducted in compliance with Advisers Act Rule 206(4)-2 (the "Custody Rule") will in many cases satisfy the conditions of the Proposed Rules, compliance with the Custody Rule is not sufficient to satisfy the Proposed Rules (or vice versa). The Proposed Rules differ from the Custody Rule's audit approach in certain key respects, including, among other things:

- Annual audits are required for a private fund client even if the Registered Adviser obtains a surprise examination;
- Auditor engagement letters must require the auditor to notify the SEC's Division of Examinations upon the auditor's termination or issuance of a modified opinion;
- Audited financial statements must be distributed to investors "promptly" upon completion of the audit, and not necessarily within 120 days of the end of the fund's fiscal year (please note that private fund managers relying on the audit approach under the Custody Rule would still need to comply with the Custody Rule's distribution timing requirements);
- The Proposed Rules do not provide an exception from the audit requirement for fee deduction or where the adviser has custody solely because a related person has custody of a client's funds or securities (as is the case for the Custody Rule); and
- Registered Advisers that do not control, are not controlled by and are not under common control with, a private fund that they advise (e.g., certain subadvisers) would be required to take all reasonable steps to cause the private fund to undergo a financial statement audit.

Adviser-Led Secondaries Rule. The Proposed Rules would require a Registered Adviser engaging in an adviser-led secondary transaction for a private fund client to distribute to investors, prior to the completion of the transaction:

- A fairness opinion prepared by an independent opinion provider (i.e., an entity that provides fairness opinions in the course of its business and is not a related person of the Registered Adviser) and
- A written summary of any material business relationships within the past two years between the Registered Adviser and the independent opinion provider.

Compliance Rule Amendments. The Proposed Rules include amendments to Advisers Act Rule 206(4)-7 (the "Compliance Rule") requiring that annual reviews conducted under the Compliance Rule be documented in writing.

Books and Records Rule Amendments. The proposal includes amendments to Advisers Act Rule 204-2 (the "Books and Records Rule") that would require Registered Advisers to retain records related to the proposed rules.

If you have any questions concerning this *Alert,* please contact Marc E. Elovitz, Kelly Koscuiszka, Meghan J. Carey, Christopher S. Avellaneda, Tarik M. Shah or your attorney at Schulte Roth & Zabel.

Further, we are gathering feedback from our clients about the impact of the SEC's proposed rules as we prepare a comment letter. You can submit comments to CommentLetters@srz.com or discuss them directly with one of the authors or your attorney at Schulte Roth & Zabel.

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