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News & Insights

SEC Proposes New Rules for Private Investment Funds

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On February 9, 2022, the SEC proposed new rules and amendments under the Investment Advisers Act of 1940 to regulate the $18-trillion private fund market. The significant new rules are intended to increase the transparency of private funds to investors by reflecting their total cost and performance, increasing compliance, and mitigating conflicts of interest. The primary proposed rules include:

QUARTERLY STATEMENTS

Registered private fund advisers would be required to prepare and distribute quarterly statements to fund investors within 45 days after the end of each quarter calendar. Such statements must be provided in clear, concise, plain English and would include the following:

- Fees and Expenses: Advisers would be required to disclose the following information in a table format:
  - A detailed accounting of all compensation, fees, and other amounts (adviser compensation) allocated or paid by the fund to the adviser or any related person during the reporting period (e.g. management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation)
  - A detailed accounting of all fees and expenses paid by the fund during the reporting period, other than adviser compensation (e.g. organizational, accounting, legal, administration, audit, tax, due diligence and travel expenses)
  - The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods that will reduce future payments or allocations to the adviser or related persons
- Portfolio Investment-Level Disclosure: Advisers would be required to disclose the following information regarding a "covered portfolio investment" (as defined in the proposed rule) in a single

table:

- A detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period
- The fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period

- Calculations and Cross References to Organizational and Offering Documents
  - Prominent disclosures identifying the manner by which expenses, payments, allocations, rebates, waivers and offsets are calculated, as well as cross-references to the relevant sections of the fund's organizational and offering documents setting forth the calculation methodology
  - Advisers to a "liquid fund" (as defined in the proposed rule) would be required to show performance based on net total return on an annual basis since the fund's inception, over prescribed time periods, and on a quarterly basis for the current year.
  - Advisers to an "illiquid fund" (as defined in the proposed rule) would be required to show performance based on the internal rate of return.
  - Advisers would remain free to include other performance metrics in the quarterly statement, so long as the quarterly statement presents the performance metrics required by the proposed rule.

These new proposed disclosures come on the heels of new SEC rules proposed on January 26, which would require more information from private equity funds filing Form PF with the SEC, including extremely aggressive and tighter timelines: one business day for certain significant regulatory events. Currently, Form PF information is not available to the public.

PRIVATE FUND AUDITS

Under the proposed rule, a fund advised by a registered investment adviser must undergo a financial statement audit at least annually or upon liquidation. The audited financial statements must be distributed promptly to current investors upon the completion of the audit. Though "promptly" is not defined in the proposed rule, the SEC states that a 120-day time period is generally appropriate to allow financial statements to be audited and to be provided to investors with timely information.

ADVISER-LED SECONDARIES

As a check against an adviser's conflicts of interest, the proposed rule requires advisers to obtain a fairness opinion from an independent opinion provider in connection with certain adviser-led secondary transactions where (a) an adviser offers fund investors the option to sell their interests in the private fund or (b) to exchange such interests for an interest in another vehicle advised by the adviser. The fairness opinion must be distributed to investors in the private fund prior to the close of the transaction.

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PROHIBITED ACTIVITIES

The proposed rule also prohibits the following activities by private funds, which have historically led to smaller investors paying a disproportionate amount of fees and expenses:

Charging certain fees and expenses to a private fund or portfolio investment, including accelerated monitoring fees; fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities; regulatory or compliance expenses or fees of the adviser or its related persons; or fees and expenses related to a portfolio investment on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment

Reducing the amount of any adviser clawback by the amount of certain taxes

Seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund

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

PREFERENTIAL TREATMENT

The proposed rule restricts fund advisers from providing preferential terms to certain investors regarding redemption or information about portfolio holdings or exposures, such as side letters. Advisers will be prohibited from providing preferential treatment to any investor in the private fund, unless the adviser provides written disclosures to current and prospective investors regarding all preferential treatment provided to investors in the same fund.

BOOKS AND RECORDS

In conjunction with the proposed rules, the SEC proposes amending Rule 204-2 of the Advisers Act to require registered advisers to retain books and records in support of their compliance with the proposed preferential treatment rule.

CYBERSECURITY

The rules propose yet another new section of Form ADV, a Form ADV-C, to disclose cybersecurity risks and incidents to investors, among other cybersecurity rules related to policies, procedures and more.

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COMPLIANCE RULE

The SEC proposes to amend the Advisers Act compliance rule to require all SEC-registered advisers to document, in writing, the annual review of their compliance policies and procedures.

The proposed rules will be open for public comment until at least April 2022 before any finalization. Private equity industry pushback is expected, as these rules, if adopted, would substantially increase compliance obligations and costs on advisers to private funds.

For more information on the proposed new rules and amendments, please contact Gerry Griffith, Eric Mikkelson, Jeremy Root or the Stinson LLP contact with whom you regularly work.

CONTACT

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