SEC PROPOSES ENHANCED PROTECTION OF PRIVATE FUND INVESTORS

The SEC has concluded that there is a need to enhance the regulation of private fund advisers registered with the SEC ("registered private fund advisers"). The SEC estimates that these advisers (approximately 5,000 in number) in effect have $18 trillion in gross assets under management, representing the value of the private funds (including hedge funds and private equity funds) they advise. On February 9, the SEC announced proposed rulemaking to address the perceived need for greater transparency in the private fund market as well as to protect against certain conflicts of interest in that market. The proposed new or modified rules would impose new disclosure requirements and prohibit certain conduct.

Most of the proposed rulemaking would apply to registered private fund advisers, while certain new rules would apply to all private fund advisers, whether or not SEC registered, and one proposal would apply to all SEC-registered advisers, whether or not they advise private funds. These rules, if adopted substantially as proposed, would represent a fundamental change in regulation of the private fund market, where there currently is no precedent for the disclosure and audit requirements proposed today. While the new disclosure would not have to be filed with the SEC or otherwise generally be made available to the public, a series of modifications to the existing books and records rules (Rule 204-2) would make these books and records rules applicable to the proposed disclosures.

This rulemaking follows the release in January of a risk alert by the Division of Examinations highlighting observations from examinations of private fund advisers as well as a proposal to amend Form PF for certain registered private fund advisers to provide more, and more timely, disclosure.

This proposed rulemaking is subject to public comment.

Also today, the SEC proposed reducing the standard settlement period for securities transactions from two business days (T+2) to one (T+1). The settlement period had been shortened from T+5 to T+3 in 1993, and from T+3 to T+2 in 2017. The SEC today also proposed requiring SEC-registered advisers and SEC-registered investment companies to adopt and implement written cybersecurity policies and procedures and to report to the SEC on a confidential basis "significant" cybersecurity incidents affecting the adviser, or its fund or private fund clients. These last two proposals are not covered by this alert.

Proposed Rulemaking

Under proposed new rules, and proposed amendments to existing rules, in each case under the Investment Advisers Act of 1940, the SEC would:

- ***Require registered private fund advisers to provide investors with quarterly statements (within 45 days after each quarter end) detailing information regarding fees and expenses. Disclosure would cover fees and expenses (itemized by category) paid by the applicable private fund (other than adviser compensation), as well compensation or other amounts (also itemized by category) paid to the adviser or its related persons***. Disclosure would also cover offsets or rebates carried forward to reduce future payments or allocations to the adviser. Adviser compensation would be broad in scope, including without limitation management, advisory, sub-advisory or similar fees or payments, and performance-based compensation.

Related persons would include officers, directors and partners of the adviser, persons controlling directly or indirectly the adviser, current employees (subject to certain exceptions) and persons under common control with the adviser. This definition is consistent with the definition used for Form ADV.

In addition to fund-level compensation, the proposed quarterly statement requirement would also cover compensation allocated or paid by each direct or indirect portfolio investment of each advised fund, as well as the percentage ownership in each such investment. The use of the term "portfolio investment" rather than "portfolio company" is intentional. Disclosure would only need to pick up information in respect of portfolio investments that allocated or paid the adviser/related person compensation during the applicable reporting period (these being "covered portfolio investments").

The proposed quarterly statement would also require prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers and offsets are calculated. The proposed quarterly statement would need to include cross references to the relevant sections of the private fund's organizational and offering documents that set forth the relevant calculation methodologies.

- ***Require private fund advisers to provide quarterly information (within 45 days after each quarter end) regarding each private fund's performance***:
    - in the case of liquid funds, the disclosure would include annual net total returns since inception, average annual net total returns over prescribed time periods, and quarterly net total returns for the current calendar year; and
    - in the case of illiquid funds, the disclosure would include the gross and net internal rate of return and gross and net multiple of invested capital for the illiquid fund to capture performance from the fund's inception through the end of the current calendar quarter. It would also cover gross internal rate of return and gross multiple of invested capital for the realized and unrealized portion of an illiquid fund's portfolio, with the realized and unrealized performance shown separately. Advisers would need to provide a statement of contributions and distributions for each illiquid fund.

The proposed rule would require advisers to include prominent disclosure of the criteria used and assumptions made in calculating the performance. Advisers could include other performance metrics in the quarterly statement as long as the quarterly statement presents the performance metrics prescribed by the proposed rule and complies with the other requirements of the proposed rule.

The SEC reminds advisers that those that include additional information should consider what other rules and regulations might apply. For example, an adviser that offers new or additional investment advisory services with regard to securities in the quarterly statement would need to consider whether such information would be subject to the marketing rule. An adviser would also need to consider whether performance information presented outside of the required quarterly statement, even if it contains some of the same information as the quarterly statement, would be subject

to, and meet the requirements of, the marketing rule. In any case, the quarterly statement would be subject to general anti-fraud provisions.

An "illiquid fund" for purposes of the disclosure rule would be 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. "Liquid funds" would be all other private funds, including those that allow for periodic investor redemptions. Documentation substantiating determinations that a private fund is a liquid or an illiquid fund would have to be retained under amended Rule 204-2.

The distribution requirement would be deemed satisfied when the quarterly statements are sent to all investors in a private fund. Where an investor is itself a pooled vehicle that is controlling, controlled by or under common control with the adviser or its related persons, the adviser must look through that pool (and any pools in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure), in order to send to investors in those pools. Advisers would be required to consolidate reporting for substantially similar pools of assets to the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading.

The rule would contain format and content requirements. Rule 204-2 would be amended to require advisers to retain books and records relating to the proposed quarterly statement.

- ***Require registered private fund advisers to obtain an audit, annually and upon liquidation, of the financial statements for each private fund they advise, and cause the auditor so retained to notify the SEC's Division of Examinations upon termination of the engagement of the auditor or the issuance of a modified audit opinion***.

  Any independent public accountant performing these audits would need to meet the standards of independence set forth in Regulation S-X and be registered with, and subject to inspection by, the PCAOB. The audit would need to be performed in accordance with US generally accepted auditing standards. Financial statements would need to be prepared in accordance with US GAAP; financial statements that are prepared in accordance with accounting standards other than US GAAP would meet the requirements of the proposed audit rule so long as they contain information substantially similar to financial statements prepared in accordance with US GAAP, material differences with U.S. GAAP are reconciled and the reconciliation, including supplementary US GAAP disclosures, is distributed to investors as part of the audited financial statements.

The SEC has proposed requiring registered private fund advisers to take "all reasonable steps" (based on facts and circumstances) to cause their private funds to undergo an audit that would satisfy the requirements of the rule, where the adviser does not control the private fund and is neither controlled by nor under common control with the fund. Promptly following the audit, the audited financial statements would be required to be distributed; the SEC declined to impose a specific time limit for distribution. The proposal would amend Rule 204-2 to require advisers to keep a copy of any audited financial statements, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee.

The notification requirement would need to be embedded in an agreement between the independent public accountant and the adviser or the private fund.

- ***Require registered private fund advisers, in connection with an adviser-led secondary transaction, to provide to investors a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider***. The SEC proposes to define these transactions as transactions initiated by the investment adviser or any of its related persons that offer the private fund's investors the choice to: (i) sell all or a portion of their interests in the private fund or (ii) 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 generally would include secondary transactions where a fund is selling one or more assets to another vehicle managed by the adviser, if investors have the option either to obtain liquidity or to roll all or a portion of their interests into the other vehicle. The proposed definition also would capture secondary transactions that may not involve a cross sale between two vehicles managed by the same adviser (*e.g.*, an arrangement for new investors to purchase fund interests from existing investors as part of a tender offer or similar transaction). Rule 204-2 would be amended to require advisers to retain books and records to support compliance with these requirements.

- ***Prohibit all private fund advisers, including those that are not SEC registered, from engaging in certain activities and practices***. These would include:
    - charging certain fees and expenses to a private fund or its portfolio investments, such as fees for unperformed services (*e.g.*, accelerated monitoring fees) and fees or expenses associated with an examination or investigation of the adviser by any governmental authority, or regulatory or compliance fees;
    - seeking reimbursement, indemnification, exculpation or limitation of liability for breach of fiduciary duty, wilful misfeasance, bad faith, negligence or recklessness in providing services to a private fund;
    - reducing the amount of an adviser clawback by the amount of certain taxes;
    - charging fees or expenses related to a portfolio investment on a non-pro rata basis; and
    - borrowing or receiving an extension of credit from a private fund client.

The proposed rule would prohibit these activities regardless of whether the private fund's governing documents permit such activities or the adviser otherwise discloses the practices and regardless of whether the private fund investors (or governance mechanisms acting on their behalf, such as limited partner advisory committees) have consented to the activities, either implicitly or explicitly. The rule also covers engaging in these activities indirectly.

- ***Prohibit all private fund advisers, including those that are not SEC registered, from providing certain types of preferential treatment that have a material negative effect on other investors, while also prohibiting all other types of preferential treatment unless disclosed to current and prospective investors***. The former category would include fund redemptions and information about portfolio holdings or other exposures of a private fund or of a "substantially similar pool of assets." Notice requirements would apply both prior to investment by an investor and on an annual basis for current investors. Rule 204-2 would be amended to require books and records to support compliance with the preferential treatment rule.

- ***Require all registered advisers, including those that do not advise private funds, to document in writing the annual review of their compliance policies and procedures***.

Transition Period and Compliance Date

The SEC has proposed a one-year transition period (following promulgation) for compliance with the proposed new and amended rules. The Division of Investment Management Staff is reviewing Staff statements, including no-action letters and staff interpretative letters, to determine whether any statements, or portions thereof, should be withdrawn or modified in connection with the rulemaking. Some letters and other Staff statements, or portions thereof, may be moot, superseded or otherwise inconsistent with the rules and, therefore, would be withdrawn or modified.

Concluding Thoughts

These proposals, which were approved by a vote of 3-1, can be expected to generate significant comments, including from industry trade groups.

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