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Investment Management Update – June 2022

WRITTEN BY

Genna Garver | Raffaele Cicala | Jackson Buday | Joseph V. Del Raso | Theodore D. Edwards | John P. Falco | John M. Ford | Barbara H. Grugan | Terrance James Reilly | Joseph A. Goldman

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Covering legal developments and regulatory news for funds, their advisers, and industry participants for the quarter ended March 31, 2022.

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RULEMAKING AND GUIDANCE

FINRA Issues Guidance Clarifying Liability for Chief Compliance Officers

03.17.22

On March 17, the Financial Industry Regulatory Authority (FINRA) issued a notice, clarifying when chief compliance officers (CCOs) will face liability as supervisors under FINRA Rule 3110.[1] Under Rule 3110, member firms are required to designate individual supervisors and identify their responsibilities as a part of implementing an overall system to "achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."[2] Ultimate responsibility for supervisory obligations in Rule 3110 lies with a member firm's president, CEO, or equivalent officer or individual.

In contrast, a CCO and other individuals on a firm's compliance team are not normally part of a firm's supervisory structure required under Rule 3110.[3] FINRA's notice characterizes compliance as an advisory function distinct from the supervisory responsibilities of individuals within a firm's business units. CCOs set compliance guidelines and advise supervisors on how to carry out their obligations under Rule 3110, but "written supervisory procedures document the supervisory system to ensure that compliance guidelines are being followed."[4] In cases where a CEO or similar individual also occupies the position of CCO, liability is easy to assess based on the non-CCO position.

When a CCO does not occupy another position, FINRA's notice clarifies that a CCO is subject to liability under Rule 3110 only when the firm explicitly or impliedly designates the CCO as having supervisory responsibilities. "A CCO is not subject to liability under Rule 3110 because of the CCO's title or because the CCO has a compliance function at a member firm."[5] In addition to situations where firms designate CCOs as having supervisory obligations in their written submissions to FINRA, such as by assigning the CCO to maintain or enforce supervisory procedures, firms can designate the CCO as having supervisory responsibilities in several ways. A CEO or other business manager may designate supervisory responsibility on an ad hoc basis. Supervisory responsibility may be found implicitly where a CCO is tasked with undertaking a review of suspicious activity or exercising oversight over specific persons in response to an incident. FINRA will bring a Rule 3110 enforcement action "[o]nly in circumstances when a firm has expressly or impliedly designated its CCO as having supervisory responsibility."[6]

If a CCO has supervisory responsibility, FINRA will bring an action under Rule 3110 "only if the CCO has failed to

discharge those responsibilities in a reasonable manner."[7] CCOs are not held to a higher or lower standard than any other individual with supervisory responsibility under Rule 3110. Reasonableness is a fact-sensitive inquiry. Similarly, even where a CCO has supervisory responsibilities and fails to reasonably discharge them, FINRA has discretion to make charging decisions based on "the same factors that could apply to any individual who has supervisory responsibility under Rule 3110."[8] However, FINRA noted factors that could weigh against charging a CCO may include "insufficient support" from management or poorly defined supervisory responsibilities.[9] FINRA will also examine "whether it is more appropriate to charge the firm or its president" or an individual, such as a business line manager, who had "more direct responsibility for the supervisory task at issue."[10]

This guidance comes after industry groups and bar associations asked FINRA and the SEC for more clarity regarding CCO responsibility, citing increasing apprehension among CCOs at the prospect of enforcement actions directed at them. FINRA's guidance makes it clear that CCOs are not the personal guarantors of a firm's compliance with applicable regulations; CCOs are only responsible for failures to discharge their own designated supervisory authority. It also reinforces FINRA's position that supervisory responsibility should occur primarily on the business side, and absent specific delegation, a firm's compliance department does not directly supervise business units.

The SEC has not issued comparable guidance, but FINRA's notice should provide CCOs and other compliance personnel reassurance as to the scope of their liability and their obligations to supervise other employees in the firm. The notice also provides that CEOs and other managers cannot escape their supervisory responsibilities just because of the presence of a CCO or compliance team. Absent a specific designation of supervisory responsibilities to a CCO, ultimate responsibility for ensuring compliance with securities laws and regulations — at least in member firms — remains with direct supervisors and ultimately firm leadership. It is important for CCOs to make sure that their roles are properly defined to limit exposure under FINRA's rules.

A copy of FINRA's Regulatory Notice 22-10 can be found at https://www.finra.org/rules-guidance/notices/22-10.

[1] FINRA Reminds Member Firms of the Scope of FINRA Rule 3110 as it Pertains to the Potential Liability of Chief Compliance Officers for Failure to Discharge Designated Supervisory Responsibilities, Regulatory Notice 22-10 (Mar. 17, 2022).
[2] *Id.* at 2.
[3] *Id.*
[4] *Id.* at 3.
[5] *Id.*
[6] *Id.*
[7] *Id.* at 4.
[8] *Id.*
[9] *Id.* at 5.
[10] *Id.*

SEC Throws Down the Gauntlet and Proposes Significant New Private Fund Adviser Rules/Amendments to Existing Investment Advisers Act Rules

02.09.22

On February 9, the Securities and Exchange Commission (SEC) proposed numerous new rules and amendments to existing rules and Form ADV under the Investment Advisers Act of 1940, as amended (Advisers Act). The proposed changes significantly impact private funds, as well as compliance, cybersecurity risk management, and books and records requirements for all registrants.

Proposed Private Fund Adviser Rules

The SEC proposed new Advisers Act Rules 211(h)(1)-1, 211(h)(1)-2, 206(4)-10, 211(h)(2)-1, 211(h)(2)-2, and 211(h)(2)-3, which are specifically and only applicable to private fund advisers. The proposals follow on the heels of the SEC proposing significant changes to Form PF and the Division of Examination's (Division) second private fund adviser Risk Alert, "*Observations from Examinations of Private Fund Advisers*." As discussed in our January 26 client advisory, SEC Chair Gary Gensler believes the SEC must "grow and evolve" with the private fund industry, while focusing on overhauling disclosure requirements in private funds, particularly for fees and expenses. Similar to the Form PF proposal, Commissioner Peirce declined to support the new rules, expressing what she sees as a "sea change" in the SEC's mission and a departure from the SEC's historical view that sophisticated accredited investors can fend for themselves.[1] While concerned the SEC is diverting resources from protecting retail investors and to the "apparently pressing need of protecting millionaire investors from private fund advisers," Commissioner Peirce said these proposals may have a "silver lining by signaling a new belief that all investments should be open to all investors." She also expressed concern that the proposals' increased regulatory burden could hinder capital formation.

Many of the proposed private fund adviser rules follow industry best practices and SEC guidance from the Division's Risk Alerts. Indeed, many private fund advisers will find they already conduct their operations in line with all or a majority of the proposals. However, at least a few may come as a surprise and could disrupt the industry or at least increase the operating costs of private fund advisers.

Definitions Rule 211(h)(1)-1

The first of the proposed private fund adviser rules is the Definitions Rule, which would contain numerous definitions for purposes of the other rules proposed under Advisers Act Section 211 discussed below, including but not limited to the terms "adviser clawback," "adviser-led secondary transaction," "Gross IRR," and "Gross MOIC." Yes, these terms mean the proposals include certain performance reporting requirements — *see Quarterly Statements Rule 211(h)(1)-2 below*! Clearer, standardized definitions on performance reporting *may* be a welcome change from the SEC's new Marketing Rule (Advisers Act Rule 206(4)-1),[2] which does not prescribe any particular calculation of gross or net performance for advertisements.[3] The proposing rule release asks for a number of comments on how to define these terms and how to address specific circumstances, such as whether or not to include no-fee, no-carry investor interests in calculating performance under these definitions. Commenters will likely raise additional concerns during the comment period, including on the use of model fees and calculating performance for unrealized investments. Perhaps the proposals will give the industry a second chance to raise questions left unanswered under the Marketing Rule.

Quarterly Statements Rule 211(h)(1)-2

Registered private fund advisers (and those required to be registered) to a private fund that has at least two full calendar quarters of operating results would need to prepare and distribute a quarterly statement to private fund investors, within 45 days after each calendar quarter end, that includes certain standardized disclosures on the cost of investing in the private fund and the private fund's performance. If adopted as proposed, the statement would need to include prominent disclosure on the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated and include cross references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology. Specifically, the statements would include:

- ***Fund Table*.** The following information would be required to be presented both before and after the application of any offsets, rebates, or waivers:

- A detailed accounting of all compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons by the fund during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation;

- A detailed accounting of all fees and expenses paid by the private fund during the reporting period, with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and

- The amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the adviser or its related persons.

- ***Portfolio Investment Table*.** The following information for each covered portfolio investment includes:

- A detailed accounting of all portfolio investment compensation allocated or paid to the investment adviser or any of its related persons by the covered portfolio investment during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, presented both before and after the application of any offsets, rebates, or waivers; and

- The fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period, or zero, if the fund does not have an ownership interest in the covered portfolio investment, along with a brief description of the fund's investment.

- ***Performance Table.*** The following performance measurements, with equal prominence, along with prominent disclosure of the criteria used and assumptions made:

- For each liquid fund, annual net total returns for each calendar year since inception, average annual net total returns over the one-, five-, and 10-calendar year periods, and quarterly cumulative net total returns for the current calendar year as of the end of the most recent calendar quarter covered by the statement; and

- For illiquid funds, since inception of the illiquid fund through the end of the quarter covered by the quarterly statement (or, to the extent quarter-end numbers are not available at the time the adviser distributes the quarterly statement, through the most recent practicable date) and computed without the impact of any fund-level subscription facilities: Gross IRR and gross MOIC for the illiquid fund; Net IRR and net MOIC for the illiquid fund; Gross IRR and gross MOIC for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately; and a statement of contributions and distributions for

the illiquid fund (as such terms are defined by the proposed Definitions Rule 211(h)(1)-1).

The distinction between liquid and illiquid funds as defined by the proposal is that illiquid funds are generally closed-end funds (having a limited life and not continuously raising capital), which do not offer periodic redemption options (other than in exceptional circumstances, such as in response to regulatory events) or otherwise generally provide opportunities to withdraw before termination, and do not routinely invest in publicly traded securities and derivative instruments, except for investing a de minimis amount of liquid assets. To prepare the proposed statements, advisers would be required to make a determination as to whether each of their funds fall within the definition of illiquid funds or are otherwise deemed liquid funds.

Importantly, Footnote 62 of the proposing release for the private fund rules makes clear that the SEC's Marketing Rule would generally not apply to information required to be included in a quarterly statement. However, if an adviser chooses to include additional information in a quarterly statement, such information may be subject to the Marketing Rule. Also, if the same required information is presented outside of the quarterly statement, the information in that different context may be subject to the Marketing Rule.[4] What's surprising about the proposal is that unlike the final Marketing Rule, the proposal requires reporting of private fund performance over one-, five-, and 10-year periods. Indeed, in the final Marketing Rule's adopting release, the SEC specifically excepted private funds from that prescribed time period requirement for performance advertisements and stated, "requiring advisers to provide performance results of private funds over one-, five-, and ten-year periods in advertisements will not provide investors with useful insight into how the advertised portfolio(s) performed during different market or economic conditions."[5]

Given the proposed Prohibited Practices Rule discussed below, the cost of providing these required quarterly statements to investors could be deemed a regulatory compliance cost of the adviser that would not be charged to their private funds. This is just one of the additional operating costs private fund advisers face in light of the proposed rules.

Private Fund Audit Rule 206(4)-10

Private fund advisers registered or required to be registered must audit their funds at least annually and upon liquidation by an independent public accountant. The proposal would require that:

- The audit is performed by an independent public accountant that meets the standards of independence described in Rule 2-01(b) and (c) of Regulation S-X and that is registered with, and subject to, regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the Public Company Accounting Oversight Board in accordance with its rules;

- The audit meets the definition in Rule 1-02(d) of Regulation S-X, the professional engagement period, which will begin and end as indicated in Regulation S-X Rule 2-01(f)(5);

- Audited financial statements are prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP) or, in the case of financial statements of private funds organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the U.S. (foreign private funds), contain information substantially similar to statements prepared in accordance with U.S. GAAP and material differences with U.S. GAAP are reconciled;

- **Promptly** after the completion of the audit, the private fund's audited financial statements, which include any reconciliation to U.S. GAAP prepared for a foreign private fund, including supplementary U.S. GAAP disclosures, as applicable, are distributed to investors;

- Pursuant to a written agreement between the independent public accountant and the adviser or the private fund, the independent public accountant that completes the audit notifies the SEC by electronic means directed to the Division of Examinations (1) promptly upon issuing an audit report to the private fund that contains a modified opinion; and (2) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed; and

- For a private fund that the adviser does not control and is neither controlled by nor under common control with (*e.*, sub-advisers to private funds), the adviser is prohibited from providing investment advice, directly or indirectly, to the private fund if the adviser fails to take all reasonable steps to cause the private fund to undergo a financial statement audit that meets these requirements.

While these audit requirements may be currently satisfied by many private fund managers availing themselves of the audit exemption under the Advisers Act Custody Rule 206(4)-2, there are some differences between those requirements and the proposed rule. Most importantly, the proposed rule requires **prompt** delivery of financial statements, rather than the Custody Rule's requirement for statements to be delivered within 120 days of the fund's fiscal year end. In the proposing release for the private adviser rules, the SEC stated that it believes a 120-day time period is "generally appropriate" for financial statements of an entity to be audited and to provide investors with timely information. However, the SEC states that "promptly" is meant to provide flexibility for delayed delivery without affecting investor protection in light of the fact that there is not an alternative method by which to satisfy the proposed rule as there is under the Custody Rule (*i.e.,* undergo a surprise examination). This flexibility should provide comfort to an adviser who reasonably believes that a fund's audited financial statements would be distributed within the required timeframe, but then fails to have them distributed in time under certain unforeseeable circumstances. Another difference from the Custody Rule's requirements is the additional requirement that an adviser who does not control the private fund they manage must take all reasonable steps to cause the private fund to undergo a financial statement audit, which could include the additional step of adding the requirement in its contractual agreement, such as the sub-advisory agreement in the case of private fund subadvisors.

Commenters will likely seek clarity on whether an adviser may rely on the Division of Investment Management's 2014 Custody Rule guidance regarding audits of special purpose vehicles (SPVs).[6] Under that guidance, advisers generally may treat the assets of SPVs as assets of their related pooled investment vehicle clients as long as (1) the assets of the SPV are considered within the scope of the pooled investment vehicle client's financial statement audit; and (2) the SPV has no owners other than the adviser, the adviser's related person(s), or pooled investment vehicles controlled by the adviser or the adviser's related person(s). Many advisers rely on that guidance in forgoing the direct audit of aggregator SPVs.

Unlike the other proposed private fund rules, which were proposed under the SEC's general rulemaking authority, the SEC proposed this rule under its anti-fraud authority under Advisers Act Section 206. The proposed audit requirement would increase protection against misappropriation by closing the loop for advisers not currently relying on the Custody Rule's audit exemption. Additionally, the audit requirement would also serve as a check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees.

Prohibited Practices Rule 211(h)(2)-1

All private fund advisers — **whether registered or exempt** — would be prohibited from, directly or indirectly:

- 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 (including accelerating monitoring fees);
- Charging the private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority;
- Charging the private fund for any regulatory or compliance fees or expenses of the adviser or its related persons;[7]
- 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;
- 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;
- 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; and
- Borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit from a private fund client.

Prohibiting exculpation and indemnification for **negligence** would significantly change the industry norms of providing exculpation and indemnification except in instances of **gross negligence**. Notably, investors **cannot** consent to waive these prohibitions. The SEC has requested comment on whether the final prohibited activities rule should prohibit limiting liability for "gross negligence," or if ordinary negligence, as proposed, would be more appropriate, and if advisers would face increased insurance rates as a result. This proposal in particular could increase advisers' operating costs.

Adviser-Led Secondaries Rule 211(h)(2)-2

The proposal would make it unlawful for a private fund adviser who is registered, or required to be registered, to complete an adviser-led secondary transaction where an adviser (or its related persons) offers fund investors the option to sell their interests in the private fund, or to convert or exchange them for new interests in another vehicle advised by the adviser or its related persons, unless the adviser, prior to the closing of the transaction, distributes to investors in the private fund:

- A **fairness opinion from an independent opinion provider**; and
- A summary of any material business relationships the adviser or any of its related persons has, or has had

within the past two years, with the independent opinion provider.

For purposes of the rule, 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 (1) sell all or a portion of their interests in the private fund; or (2) 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.

Side Letter/Preferential Treatment Rule 211(h)(2)-3

All private fund advisers — **whether registered or exempt** — would be prohibited from directly or indirectly:

- Granting an investor in a private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets;

- Providing information regarding the portfolio holdings or exposures of the private fund, or of a substantially similar pool of assets, to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets; or

- Providing, directly or indirectly, **any other preferential treatment** to any investor in a private fund unless the adviser provides:

- Prior to investment in the private fund, a written notice to each prospective investor that provides specific information regarding any preferential treatment the adviser or its related persons provide to other investors in the same private fund; and

- On at least an annual basis, a written notice to current investors that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided, if any.

Industry best practice is to not give preferential withdrawal or transparency rights in side letters and to disclose the possibility of the fund entering into side letters with certain investors to vary the terms of the fund's governing documents with respect to that particular investor. However, the proposal would require periodic notice of specific side letter provisions. The cost of providing these required notices could be deemed a regulatory compliance cost of the adviser that would not be charged to the fund. This is potentially another additional operating cost private fund advisers face in light of the proposed rules.

Amendments to Advisers Act Applicable to All RIAs

Compliance Rule 206(4)-7

The proposal includes amendments to Advisers Act Compliance Rule 206(4)-7, requiring **all registered advisers (and those required to be registered) to document their annual review in writing**. The staff expects this requirement to help exam staff understand the adviser's compliance program, identify weaknesses, and determine whether the adviser is in compliance with the rule. While most advisers document their annual review

report to management,[8] practices do vary in part out of concern that such documents will increase enforcement risks associated with breaches or potential deficiencies identified. The proposal, if adopted, would align the Advisers Act Compliance Rule with the Investment Company Act Compliance Rule 38a-1, which currently requires registered fund CCO's to provide a written report to the fund's board at least annually.

Unfortunately, the SEC did not use this rulemaking opportunity to provide comfort to CCOs on the issue of personal liability despite recent calls for clarity from industry participants.[9] Given the staff's intended use of the proposed written annual reviews to understand a firm's compliance program, CCOs could consider using the required documentation as a means of assessing and communicating the availability of resources and empowerment concerns as part of their review process, which could mitigate personal liability risks.

Books and Records Rule 204-2

The proposal to amend the current Advisers Act Books and Records Rule 204-2 would require registered private fund advisers to make and keep records relating to the quarterly statements required under proposed Quarterly Statements Rule 211(h)(1)-2, the financial statement audits performed under proposed Private Fund Audit Rule 206(4)-10, fairness opinions required under proposed Adviser-Led Secondaries Rule 211(h)(2)-2, and disclosure of certain types of preferential treatment required under proposed Preferential Treatment Rule 211(h)(2)-3. Specifically, the following books and records would be required:

- Any notice of preferential treatment required to be delivered, as well as a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee;
- A copy of any quarterly statement distributed, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee;
- All records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any quarterly statement delivered;
- For each private fund client:
- A copy of any audited financial statements prepared and distributed, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee; or
- A record documenting steps taken by the adviser to cause a private fund client that the adviser does not control, is not controlled by, and with which it is not under common control to undergo a financial statement audit.
- Documentation substantiating the adviser's determination that a private fund client is a liquid fund or an illiquid fund; and
- A copy of any fairness opinion and material business relationship summary distributed in connection with an adviser-led secondary transaction, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee.

Comment Period

Comments on the proposed rules and amendments were due to the SEC by April 25, 2022.

* * *

If you have any questions regarding these proposed rules and amendments to the Advisers Act and Form ADV, the regulation of investment advisers, CCO liability, or questions otherwise relating to the above alert, please contact Genna Garver.

A copy of the SEC's proposed rules and amendments to the Advisers Act can be found at https://www.sec.gov/rules/proposed/2022/ia-5955.pdf.

[1] *See* https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922.
[2] For more information on the SEC's new marketing rule, *see* https://www.troutman.com/insights/the-secs-new-investment-adviser-marketing-rule-merging-and-modernizing-advertising-and-solicitation-regulation.html.
[3] Under the Marketing Rule's final adopting release, the SEC stated private funds could choose to use money-weighted returns instead of time-weighted returns for purposes of the marketing rule and can choose which fees and expenses to be considered in preparing net performance. *See* https://www.sec.gov/rules/final/2020/ia-5653.pdf. Registered advisers are required to comply with the new Marketing Rule by November 4, 2022.
[4] The final Marketing Rule adopting release states that information in a statutory or regulatory notice, filing, or other required communication would be excluded from the definition of an "advertisement," provided the information is reasonably designed to satisfy the requirements. However, if an adviser includes information that is not reasonably designed to satisfy its obligations under applicable law, and such additional information offers the adviser's investment advisory services with regard to securities, then that information will be considered an "advertisement" for purposes of the rule. *See* https://www.sec.gov/rules/final/2020/ia-5653.pdf.
[5]*See* https://www.sec.gov/rules/final/2020/ia-5653.pdf at page 182.
[6] *See* https://www.sec.gov/investment/im-guidance-2014-07.pdf.
[7] The proposing release states that the proposed rule, if adopted, would not prohibit an adviser from charging a private fund for all the costs associated with a regulatory filing of the fund, such as Form D. However, it's not clear if Form PF expenses or the quarterly statements required by the proposed rule could be allocated to the fund rather than the adviser.
[8] *See* https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/about/190618_IMCTS_slides_after_webcast_edits.pdf. The 2019 Investment Management Compliance Testing Survey conducted by ACA Compliance and the Investment Advisers Association shows that respondents documented their annual compliance program review results as follows: 57% prepared lengthy written reports (down from 65% reported in the 2018 survey); 33% prepared short memorandum summarizing the findings; and 3% prepared informal documentation (notes).
[9] The National Society of Compliance Professionals published a framework to evaluate firm and CCO liability after conducting multiple industrywide surveys with its 2,000+ membership of CCOs and other

compliance professionals. A copy of the NSCP Framework can be found at https://nscp.org/wp-content/uploads/2022/01/NSCP-Firm-and-CCO-Liability-Framework-Final-12-21-21.pdf.

SEC Proposes Cybersecurity Risk Management Rules and Amendments for Registered Investment Advisers and Funds

02.09.22

On February 9, the SEC proposed rules related to cybersecurity risk management for registered investment advisers, registered investment companies and business development companies (funds), as well as amendments to certain rules that govern registered investment adviser and fund disclosures.

The proposed rules would require registered investment advisers and funds to adopt and implement written cybersecurity policies and procedures designed to address cybersecurity risks that could harm advisory clients and fund investors. The proposed rules also would require registered investment advisers to report significant cybersecurity incidents affecting the adviser or its fund or private fund clients to the SEC on a new confidential form.

To further help protect investors in connection with cybersecurity incidents, the proposal would require registered investment advisers and funds to publicly disclose cybersecurity risks and significant cybersecurity incidents that occurred in the last two fiscal years in their brochures and registration statements.

Additionally, the proposal would set forth new recordkeeping requirements for registered investment advisers and funds designed to improve the availability of cybersecurity-related information and help facilitate the SEC's inspection and enforcement capabilities

Comments on the proposed rules were due to the SEC by April 11, 2022.

The SEC's proposed rule is available at https://www.sec.gov/rules/proposed/2022/33-11028.pdf.

SEC Proposes Shortening the Securities Transaction Settlement Cycle (T+1)

02.09.22

On February 9, the SEC proposed rule changes intended to reduce risks in the clearance and settlement of securities, including by shortening the standard settlement cycle for most broker-dealer transactions in securities from two business days after the trade date (T+2) to one business day after the trade date (T+1).

In addition to shortening the standard settlement cycle, the proposal includes rules directed at broker-dealers and registered investment advisers to shorten the process of confirming and affirming the trade information necessary to prepare a transaction for settlement so that it can be completed by the end of trade date.

These proposed rule requirements are designed to protect investors, reduce risk, and increase operational efficiency. If adopted, the SEC proposes to require compliance with a T+1 standard settlement cycle by March 31,

2024.

Comments on the proposed rule were due to the SEC by April 11, 2022.

The SEC's proposed rule is available at https://www.sec.gov/rules/proposed/2022/34-94196.pdf.

Risk Alert: Observations from Examinations of Private Fund Advisers

01.27.22

On January 27, the staff of the SEC's Division of Examinations (formerly known as the Office of Compliance Inspections and Examinations or OCIE, and now known as EXAMS) released a Risk Alert, providing an overview of compliance issues observed by EXAMS staff in examinations of registered investment advisers that manage private funds (Private Fund Advisers). This Risk Alert is a sequel or supplement to a prior Risk Alert released by EXAMS on June 23, 2020 (the 2020 Private Fund Adviser Risk Alert). The observations in this Risk Alert and the 2020 Private Fund Adviser Risk Alert were drawn from over five years of examinations of Private Fund Advisers.

In light of the significant role of Private Fund Advisers in the financial markets, EXAMS published this new Risk Alert to detail additional observations or concerns, such as (1) failure to act consistently with disclosures; (2) use of misleading disclosures regarding performance and marketing; (3) due diligence failures relating to investments or service providers; and (4) use of potentially misleading "hedge clauses."

The following summarizes some of the Private Fund Adviser deficiencies noted in the Risk Alert:

- A failure of Private Fund Advisers to act consistently with material disclosures made to clients or investors. For example, EXAMS staff observed Private Fund Advisers that did not follow practices described in their limited partnership agreements (LPAs), operating agreements, private placement memoranda, due diligence questionnaires, side letters or other disclosures (fund disclosures) regarding the use of Limited Partner Advisory Committees (LPACs), and the commitment to bring conflicts to the LPACs for review and consent.

- Failure to comply with LPA liquidation and fund extension terms. EXAMS staff observed advisers that extended the terms of private equity funds without obtaining the required approvals or without complying with the liquidation provisions described in the funds' LPAs, which, among other things, resulted in potentially inappropriate management fees being charged to investors.

- Failure to invest in accordance with fund disclosures regarding investment strategy. EXAMS staff observed Private Fund Advisers that did not comply with investment limitations in fund disclosures. For example, the staff observed Private Fund Advisers that implemented an investment strategy that diverged materially from those described to investors in fund disclosures.

- Failure to follow fund disclosures regarding adviser personnel changes. EXAMS staff observed advisers that did not adhere to the LPA "key person" process after the departure of several adviser principals.

- EXAMS staff has observed Private Fund Advisers providing to investors or prospective investors misleading or inaccurate performance track records.

- EXAMS staff observed Private Fund Advisers that did not maintain books and records supporting predecessor

performance at other advisers. In addition, the staff observed Private Fund Advisers that appeared to have omitted material facts about predecessor performance.

- Lack of reasonable investigation or due diligence into underlying investments or funds. In addition, the EXAMS staff observed advisers that failed to perform adequate due diligence on important service providers, such as alternative data providers and placement agents.

- The EXAMS staff observed Private Fund Advisers that outlined a due diligence process in fund disclosures but did not maintain policies and procedures related to due diligence that were tailored to their advisory businesses.

- Use of hedge clauses may be misleading. Whether a clause in an agreement, or a statement in disclosure documents provided to clients and investors, that purports to limit an adviser's liability (*i.e.*, a "hedge clause) is misleading and would violate Sections 206(1) and 206(2) of the Advisers Act depends on all of the surrounding facts and circumstances. EXAMS staff observed Private Fund Advisers that included potentially misleading hedge clauses in documents that purported to waive or limit the Advisers Act fiduciary duty except for certain exceptions, such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud. Such clauses could be inconsistent with Sections 206 and 215(a) of the Advisers Act.

The Risk Alert is available at https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf.

SEC Proposed Form PF Amendments Kick Off SEC Chair Gensler's Push for Increased Transparency for Private Funds

01.26.22

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On January 26, the SEC approved proposed amendments to Advisers Act Rule 204(b)-1 and Form PF to require prompt reporting of certain extraordinary events that may signal distress or market instability. The proposals are material and could significantly impact private fund advisers, including smaller advisers falling below the current threshold for large reporters.

Notably, the proposal would reduce the reporting threshold for large private equity fund advisers from $2 billion to $1.5 billion in assets under management.[1] Chair Gary Gensler hopes this change will recalibrate the scope of reporting by fund managers back to the proportion of the industry covered (based on committed capital) when Form PF was initially adopted, which represents about 75% of the assets under management.[2]

Specifically, the proposal would require large hedge fund advisers to report within one business day:

- Certain extraordinary investment losses (loss equal to or greater than 20% of a fund's most recent net asset value over a rolling 10 business day period);

- Significant margin and counterparty default events (*e.g.*, a cumulative increase in margin of more than 20% of the reporting fund's most recent net asset value over a rolling 10 business day period);[3]

- Material changes in prime broker relationships (*e.g.*, material changes to the fund's ability to trade or an outright termination of the prime brokerage relationship for default or breach of the prime brokerage agreement);

- Changes in unencumbered cash (*e.g.*, the value of the reporting fund's unencumbered cash declines by more than 20% of the reporting fund's most recent net asset value over a rolling 10 business day period);[4]

- Significant disruption or degradation of the reporting fund's key operations[5] (*e.g.*, a 20% disruption or degradation of normal volume or capacity); and

- Events associated with withdrawals and redemptions (exceeding 50% of the most recent net asset value).

All private equity fund advisers would be required to report within one business day events pertaining to:

- The execution of adviser-led secondary transactions;[6]

- Implementation of general partner or limited partner clawbacks;[7]

- Investors' removal of a fund's general partner; and

- Investors' election to terminate a fund's investment period, or investors' election to terminate a fund.

Large private equity fund advisers would also be required to provide information regarding fund strategies':

- Use of leverage and portfolio company;

- Financings;

- Controlled portfolio companies and borrowings;

- Fund investments in different levels of a single portfolio company's capital structure; and

- Portfolio company restructurings or recapitalizations.

Large liquidity fund advisers would be required to report substantially the same information that money market funds would report on Form N-MFP, as the SEC proposes to amend it.

Not all of the commissioners are on board with the proposals. Commissioner Peirce voiced fundamental objections, including the shift in Form PF's scope and purpose, which was primarily intended to assist the Financial Systemic Oversight Commission (FSOC) in its monitoring obligations under the Dodd-Frank Act. She stated, "Congress didn't conceive Form PF to inoculate well-heeled investors against fund failures." While acknowledging certain information gaps in the current Form PF, she questioned whether the SEC's desire to fill these gaps was "born of necessity or curiosity," and argued the proposing release provides scant evidence that the amendments would enhance the ability to monitor systemic risk. There is, of course, support for increased concerns of systemic risk, mainly stemming from the market stress of the global pandemic. Last year, at the request of U.S. Treasury Secretary and FSOC Chairperson Janet L. Yellen, the FSOC reconvened its Hedge Fund Working Group, which had last reported to FSOC in 2016. Commissioner Peirce expressed concern that the real-time reporting requirements were essentially inadequately justified micromanagement. As for the reduction in the

reporting threshold, Commissioner Peirce believes the threshold should be increased rather than reduced because market growth has increased the number of funds above the threshold. Indeed, requiring smaller fund advisers to report in real time, while they are in the midst of the extraordinary event, could be potentially harmful.

The proposed Form PF amendments come amid a larger push by Chair Gensler to heighten regulation of private equity and hedge funds, as Gensler continues his focus on increasing transparency and market efficiency in those sectors. In a virtual speech to the Washington, DC Exchequer Club last month, Gensler said that he intends to use the agency's "authorities to bring greater transparency and competition into that market," which "helps portfolio companies on the one hand, and the pensions and endowments that are investing in that space on the other."[8]

Gensler indicated a desire to overhaul disclosure requirements in private funds as early as May 2021. While addressing the U.S. House Appropriations Committee's Subcommittee on Financial Services and General Government, Gensler pointed to the industry's rapid growth as a justification for increased scrutiny. In his testimony, Gensler noted the "[eight] percent increase over the last five years" in private equity and capital funds.[9] Gensler argued that because "[t]here is no self-regulatory organization for investment advisers like there is for broker-dealers," the SEC must "grow and evolve with the industry."[10] Gensler again cited the industry's size in his speech last month, estimating that private equity and hedge funds hold approximately $17 trillion in assets under management, and charge about $250 billion in fees and expenses each year.[11]

Institutional investors also are pushing for enhanced disclosure requirements by private fund advisers. In December 2021, leaders of various public sector unions — including the National Education Association (NEA); American Federation of State, County, and Municipal Employees (AFSCME); and Service Employees International Union (SEIU) — wrote an open letter to Gensler, emphasizing the need for "proper oversight."[12] Adopting similar recommendations from another group of unions and advocates for financial reform,[13] union leaders specifically urged the SEC to "consider updates to Form PF requirements to capture more comprehensive information about the holdings, sources of credit and other practices of private fund advisers," among other proposed reforms.[14]

Public sector unions are not the only organizations voicing concern about a lack of transparency by private fund advisers. The Institutional Limited Partners Association (ILPA) wrote to Gensler in May 2021, applauding him for his "statement at [his] confirmation hearing that the disclosure of fees and conflicts of interests by private equity advisers sits 'at the heart of the Advisers Act.'"[15] ILPA, which says its "550+ member institutions represent over USD 2 trillion in private equity assets under management globally," wrote that "under current SEC regulations, limited partners routinely fail to receive adequate transparency in these areas."[16]

Further, Gensler has voiced concern that investors may not fully understand the fees they are charged. He said that investors are billed for "consulting fees, advisory fees, monitoring fees, servicing fees, transaction fees, [and] director's fees," and many believe they are assessed unnecessary costs.[17] As a result, Gensler said that more transparency in this area "could help lower the cost of capital for businesses raising money," "raise the returns for the pensions and endowments behind the limited partner investors," and "help workers preparing for retirement and families paying for their college educations."[18]

It will be important for private equity and hedge fund advisers to keep track of these proposals as they near approval.

If you have any questions regarding the proposed amendments to Form PF, the regulation of private equity and hedge fund fees, SEC enforcement actions, your company's policies and procedures, or questions otherwise relating to the above alert, please contact any of the Troutman Pepper attorneys listed in this newsletter.

Comments on the proposed rule and Form PF amendments were due to the SEC by March 21, 2022.

A copy of the SEC's proposed rule and Form PF amendments can be found at https://www.sec.gov/rules/proposed/2022/ia-5950.pdf.

[1] In addition to large private equity fund advisers, the current version of Form PF defines large hedge fund advisers ($1.5 billion in hedge fund assets under management) and large liquidity fund advisers ($1 billion in combined money market and liquidity fund assets under management).
[2] The current threshold only captures about 67% of the U.S. private equity industry. According to the proposing release, there were 6,910 funds with $1.60 trillion in gross assets in first quarter of 2013 and 15,584 funds with $4.71 trillion in gross assets in the fourth quarter of 2020. See pages 8 and 54 of the proposing release.
[3] Reporting would include the legal name and LEI (if any) of the counterparty. The proposal sets the threshold for reporting counterparty defaults at 5% of the most recent net asset value to limit the reports for de minimis or superficial defaults that may be the result of a short-lived operational error. See page 25 of the proposing release.
[4] The proposal would require an addition filing if the decrease in unencumbered cash were to continue past the initial 10-day period.
[5] Key operations would include the investment, trading, valuation, reporting, and risk management of the reporting fund, as well as the operation of the reporting fund in accordance with the federal securities laws and regulations. This includes a cybersecurity event that disrupts the trading volume of a reporting fund by 20% of its normal capacity, an inability to value the fund's assets because of an operational issue with a service provider, and certain severe weather events causing power outages. Reporting would require disclosure of whether the adviser has initiated a business continuity plan in response to the event.
[6] The proposal would define an "adviser-led secondary transaction" as any transaction initiated by the adviser or any of its related persons that offers private fund 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 interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.
[7] While reporting would be required upon the implementation of any general partner clawback, the proposal would require reporting when an adviser implements a limited partner clawback (or clawbacks) in excess of an aggregate amount equal to 10% of a fund's aggregate capital commitments.
[8] *See* Gary Gensler, Chairman, Sec. and Exch. Comm'n, Dynamic Regulation for a Dynamic Society (Jan. 19, 2022), https://www.sec.gov/news/speech/gensler-dynamic-regulation-20220119.
[9] *See* Gary Gensler, Chairman, Sec. and Exch. Comm'n, Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee (May 26, 2021), https://www.sec.gov/news/testimony/gensler-2021-05-26.
[10] *See id.*

[11]*See* Gensler, Dynamic Regulation for a Dynamic Society, *supra*.
[12] *See* Letter from Public Sector Unions to Gary Gensler, Chairman, Sec. and Exch. Comm'n (Dec. 7, 2021), https://www.nea.org/advocating-for-change/new-from-nea/union-letter-sec-private-equity-oversight.
[13] *See* Letter from Americans for Financial Reform to Gary Gensler, Chairman, Sec. and Exch. Comm'n (July 14, 2021), https://ourfinancialsecurity.org/2021/07/letters-to-the-regulators-afref-letter-to-the-sec-on-addressing-private-equitys-abuses/.
[14] *See* Letter from Public Sector Unions, *supra*.
[15] *See* Letter from Steve Nelson, CEO, Institutional Ltd. Partners Ass'n (LIPA) to Gary Gensler, Chairman, Sec. and Exch. Comm'n (April 21, 2021), https://ilpa.org/wp-content/uploads/2021/04/2021.4.20-ILPA-Welcome-Letter-to-Chairman-Gensler-Final.pdf.
[16] *See id.*
[17] *See* Gary Gensler, Chairman, Sec. and Exch. Comm'n, Prepared Remarks at the Institutional Ltd. Partners Ass'n Summit (Nov. 10, 2021), https://www.sec.gov/news/speech/gensler-ilpa-20211110.
[18] *See id.*

LITIGATION AND ENFORCEMENT

SEC Division of Examinations Announces 2022 Examination Priorities

03.30.22

On March 30, the staff of EXAMS announced its examination priorities for fiscal year 2022. EXAMS publishes the report annually to identify areas where it believes potential risks to investors and U.S. capital markets may exist. This year's report focused significantly on registered investment advisers (RIAs) to private funds, accurate ESG disclosures, standards of conduct issues for broker-dealers and RIAs, information security and operational resiliency, and emerging technologies and crypto assets.

Below find a summary of EXAMS's 2022 examination priorities.

Private Funds

The 2022 report notes that in the past five years, there has been a 70% increase in the assets managed by advisers to private funds — more than 5,000 SEC-RIAs manage approximately $18 trillion in private fund assets. Given the magnitude and complexity of this market, EXAMS will continue to prioritize its focus on reviewing issues under the Advisers Act, including an adviser's fiduciary duty, and will assess risks, compliance programs, conflicts of interest, and controls around material nonpublic information (MNPI).

EXAMS will als

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