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

WRITTEN BY

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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. The SEC issued the proposals under three distinct releases: (1) private fund advisers; documentation of registered investment adviser compliance reviews; (2) cybersecurity risk management for investment advisers, registered investment companies, and business development companies; and (3) shortening the securities transaction settlement cycle.

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, <u>within 45 days after each calendar quarter end</u>, 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 <u>both before and after</u> 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:
    - 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), 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 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: (i) promptly upon issuing an audit report to the private fund that contains a modified opinion; and (ii) 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 (*i.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, 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: (i) the assets of the SPV are considered within the scope of the pooled investment vehicle client's financial statement audit; and (ii) 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: (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.

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, **<u>any other preferential treatment</u>** 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.

<u>Amendments to Advisers Act Applicable to All RIAs</u>

Compliance Rule 206(4)-7

The proposal includes amendments to Advisers Act Compliance Rule 206(4)-7, requiring **<u>all registered advisers (and those required to be registered) to document their annual review in writing</u>**. 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;
- 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.

Proposed New Cyber Risk Management Rules

Proposed Advisers Act Cybersecurity Policies and Procedures Rule 206(4)-9, if adopted as proposed, would require **all registered advisers** to adopt and implement written cybersecurity policies and procedures reasonably designed to address cybersecurity risks. Proposed amendments to Advisers Act Rule 204-3, would require registered advisers to report to the SEC on Form ADV under new Item 20 of Part 2A, cybersecurity risks that could materially affect the advisory services they offer and how they assess, prioritize, and address cybersecurity risks created by the nature and scope of their business. Additionally, registered advisers would need to report descriptions of all cybersecurity incidents that have occurred within the prior two fiscal years that have significantly disrupted or degraded their ability to maintain critical operations, or have led to the unauthorized access, or use of, adviser information, resulting in substantial harm to the adviser or its clients. Most importantly, advisers would be required to submit new Form ADV-C within 48 hours after having a reasonable basis to conclude that a significant adviser cybersecurity incident or a significant fund cybersecurity incident has occurred as required by new Advisers Act Cybersecurity Incident Reporting Rule 206(4)-6. In connection with these proposed cyber risk management rules, the SEC is also proposing new recordkeeping requirements under the Advisers Act. Registered funds would also be required to comply with similar requirements under proposed new rules and amendments to existing rules and forms under the Investment Company Act.

Shortening the Securities Transaction Settlement Cycle — New Advisers Act Books and Records

The SEC also proposed a set of rules to shorten the standard settlement cycle to T+1 and improve the processing of institutional trades by broker dealers, investment advisers, and certain clearing agencies. Proposed amended Rule 15c6-1, issued under the Securities Exchange Act of 1934, as amended (Exchange Act), would shorten the standard settlement cycle for most broker-dealer transactions from T+2 to T+1 and to repeal the T+4 standard settlement cycle for firm commitment offerings priced after 4:30 p.m. If the proposal is adopted, a T+1 cycle would be implemented by March 31, 2024. Proposed Exchange Act Rule 15c6-2 would prohibit broker-dealers from entering into contracts with their **institutional customers** unless those contracts require that the parties complete allocations, confirmations, and affirmations by the end of the trade date. The SEC also proposed related amendments to the Advisers Act Books and Records Rule 204-2 to require registered advisers to maintain records of each confirmation received, and any allocation and each affirmation sent, with a date and time stamp for each allocation (if applicable) and affirmation that indicates when the allocation or affirmation was sent to the broker or dealer if the adviser is a party to a contract under proposed Rule 15c6-2. This additional requirement would only apply to **registered advisers with institutional clients** (which would include hedge fund clients, pension funds, insurance companies, and others).

Comment Period

The comment period for all three proposals is now open and ends 30 days after the date of publication in the *Federal Register*, or April 11, 2022 (which is 60 days after the issuance of the proposal on the SEC's website), whichever is later. While this is a departure from traditional comment periods — typically 60 days following publication in the federal register — as well as a departure from the 30-day comment period for the recent Form PF proposals, Chair Gensler noted the need to address publication in the *Federal Register* taking longer than desired.

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

[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, show 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 industry-wide 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.

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