

# NOW & NEXT

## Securities Alert

FEBRUARY 23, 2022

### SEC releases proposed rules on private funds and private fund advisers

By Richard L. Shamos and Bohao Zhou

The Proposed Rules would alter the private contractual relationship between private fund advisers and their investors in favor of a direct regulatory regime.



#### What's the Impact?

- / The Proposed Rules would require extensive expense and performance reporting, impose new audit requirements, and prohibit widely accepted business practices in the private funds industry
- / While a transition period for compliance of one year is provided, grandfathering provisions are not included

On February 9, 2022, the SEC [announced proposed new rules](#) under the Investment Advisers Act of 1940 (the "Advisers Act") targeting private funds and their investment advisers (the "[Proposed Rules](#)"). The Proposed Rules mark a pointed divergence from the SEC's long-established approach to fund compliance, which emphasizes disclosure and relies on private contractual relationships to regulate the behavior of industry participants, toward a regime that directly regulates the relationships between and among investment advisers and investors.

In particular, the Proposed Rules would require registered investment advisers to private funds to provide the following:

- / Detailed fund reporting on fees and expenses, including management's receipt of transaction fee income from portfolio companies
- / Conformed reporting of fund performance based on the SEC's prescribed metrics (which prohibit inclusion of the effect of subscription facilities)
- / Classification of each of the adviser's funds as either a "liquid fund" or "illiquid fund"
- / An annual audit of a fund from a PCAOB-approved auditor and in accordance with U.S. GAAP, irrespective of fund jurisdiction
- / Auditor engagement terms that authorize the auditor to report any qualification of financial statements or termination of the auditor to the SEC
- / Reasonable efforts to require other funds in which the adviser invests to conduct an audit
- / Documentation of the adviser's annual review of compliance policies and procedures

The Proposed Rules would also require all private fund advisers to provide the following:

- / Detailed disclosure of all fund side letter provisions to investors
- / A fairness opinion from a third party in connection with any adviser-led secondary transaction

In addition, the Proposed Rules would prohibit any investment adviser from engaging in the following practices:

- / Acceleration of monitoring fees received by management affiliates from a portfolio company
- / Charging as fund expenses (i) any fees and expenses incurred by the adviser in connection with a regulatory examination or investigation, or (ii) regulatory and compliance fees and expenses of the adviser and its related persons
- / Using a clawback feature in the fund agreement that is net of taxes paid by the general partner
- / Including in the fund agreement (i) a contractual disclaimer of fiduciary duty, or (ii) any limitation of liability for negligence or recklessness
- / Allocating expenses from investments to clients on any basis other than pro-rata
- / Borrowing from a fund client
- / Providing preferential redemption terms to certain investors

The Proposed Rules are being issued under Section 211(h) of the Advisers Act (passed by the Dodd-Frank Wall Street Reform and Consumer Protection Act), and represent the most aggressive reading of the SEC's authority thereunder to date, and the most substantive private funds regulations proposed under the tenure of Chairman Gary Gensler. While the Proposed Rules include a transition period for compliance of one year, they do not contain any grandfathering provisions, and so, if adopted in their current form, would apply to existing fund

agreements and side letters entered into by fund advisers and investors. Notably, the rules prohibit certain widely accepted practices in the industry and impose performance and expense reporting obligations on market participants that are likely to be inconsistent with the terms of a fund's partnership agreement. Accordingly, we encourage both fund sponsors and investors to carefully review the rules and to contact their attorney at Nixon Peabody with any questions.

A public comment period will remain open for the Proposed Rules for 60 days following the publication of the Proposed Rules on the SEC's website on February 9, 2022, or 30 days following publication of the proposing releases in the *Federal Register*, whichever is longer.

## Summary of rule amendments

As previously noted, the Proposed Rules cover broad aspects of the relationship between private fund advisers and private fund investors, including those areas described below.

### *Quarterly reporting*

§ 275. 211(h)(1)-2 requires that registered private fund advisers provide investors with *quarterly statements* detailing information about private fund performance, fees and expenses, and adviser compensation within 45 days after each calendar quarter end (unless such a quarterly statement is prepared and distributed by another person). The quarterly statement is required to include:

- / A Fund Table that discloses, at a minimum:
  - (i) 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;
  - (ii) a detailed accounting of all fees and expenses paid by the private fund during the reporting period (other than those listed in paragraph (b)(1) of this section), with separate line items for each category of fee or expense reflecting the total dollar amount; and
  - (iii) 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.
- / A Portfolio Investment Table that discloses, at a minimum:
  - (i) 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
  - (ii) 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.
- / Prominent disclosure regarding 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.

- / For a "liquid fund":
  - Annual net total returns for each calendar year since inception;
  - Average annual net total returns over the one-, five-, and ten-calendar year periods; and
  - The cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.
- / For an "illiquid fund," the following performance measures, shown since inception of the illiquid fund through the end of the quarter covered by the quarterly statement 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.
- / The date as of which the performance information is current through and prominent disclosure of the criteria used and assumptions made in calculating the performance.
- / To the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading, the adviser must consolidate the reporting to cover substantially similar pools of assets.

#### *Mandatory fund audit*

§ 275.206(4)-10 requires that registered private fund advisers undergo a financial statement audit at least annually and upon liquidation, as follows:

- / The audit is performed by an independent public accountant that meets the standards of independence described in Regulation S-X and that is registered with, and subject to regular inspection by the Public Company Accounting Oversight Board in accordance with its rules.
- / 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 United States ("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 includes any reconciliation to U.S. GAAP prepared for a foreign private fund, including supplementary U.S. GAAP disclosures, as applicable, are distributed.
- / A written agreement between the independent public accountant and the adviser or the private fund shall require that 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.

- / For a private fund that the adviser does not control and is neither controlled by nor under common control with, 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 the requirements above.

#### *Fairness opinion for adviser-led secondary transactions*

§ 275.211(h)(2)-2 provides that it is unlawful for any registered private fund advisers to complete an adviser-led secondary transaction with respect to any private fund, unless the adviser (a) obtains, and distributes to investors in the private fund, a fairness opinion from an independent opinion provider and (b) prepares, and distributes to investors in the private fund, a written 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, in each case, prior to the closing of the adviser-led secondary transaction.

#### *Prohibited activities*

§ 275.211(h)(2)-1 prohibit the following activities for all private fund advisers:

- / Charge 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;
- / Charge 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;
- / Charge the private fund for any regulatory or compliance fees or expenses of the adviser or its related persons;
- / Reduce 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;
- / Seek 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;
- / Charge or allocate 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
- / Borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client.

§ 275.211(h)(2)-3 prohibits private fund advisers from engaging in the following types of preferential treatment:

- / Grant an investor in the 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;
- / Provide 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; and
- / Provide any other preferential treatment to any investor in the private fund unless the adviser provides: (1) Advance written notice for prospective investors in a private fund. The investment adviser shall provide to each prospective investor in the private fund, prior to the investor's investment in the private fund, a written notice that provides specific information regarding any preferential treatment the adviser or its related persons provide to other investors in the same private fund. (2) Annual written notice for current investors in a private fund. The investment adviser shall distribute to current investors, on at least an annual basis, a written notice 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 in accordance with this section, if any.

#### *Record-keeping requirements for registered investment advisers*

§ 275.206(4)-7 requires all registered investment advisers to review annually the adequacy of the adviser's policies and procedures. The review and document shall be in writing, no less frequently than annually.

§ 275.204-2 requires all registered investment advisers to keep the following books and records, if applicable:

- / Originals of all written communications received and copies of all written communications sent by such investment adviser relating to: (v) Any notice required pursuant to § 275.211(h)(2)-3 as well as a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee.
- / (i) A copy of any quarterly statement distributed pursuant to § 275.211(h)(1)-2, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee; and (ii) All records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any statement delivered pursuant to § 275.211(h)(1)-2.
- / For each private fund client: (i) A copy of any audited financial statements prepared and distributed pursuant to § 275.206(4)-10, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee; or (ii) 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 pursuant to § 275.206(4)-10.

- / Documentation substantiating the adviser's determination that a private fund client is a liquid fund or an illiquid fund pursuant to § 275.211(h)(1)-2.
- / A copy of any fairness opinion and material business relationship summary distributed pursuant to § 275.211(h)(2)-2, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee.

## Looking ahead

We encourage both fund sponsors and investors to carefully review the rules. A public comment period will remain open for the Proposed Rules for 60 days following the publication of the Proposed Rules on the SEC's website on February 9, 2022, or 30 days following publication of the proposing releases in the *Federal Register*, whichever is longer.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

**[John P. Beals](#)**

617.345.1060

[jbeals@nixonpeabody.com](mailto:jbeals@nixonpeabody.com)

**[Edward F. Ughetta](#)**

212.940.3047

[tughetta@nixonpeabody.com](mailto:tughetta@nixonpeabody.com)

**[Richard L. Shamos](#)**

213.629.6157

[rshamos@nixonpeabody.com](mailto:rshamos@nixonpeabody.com)

**[Bohao Zhou](#)**

617.345.6079

[bzhou@nixonpeabody.com](mailto:bzhou@nixonpeabody.com)

**[Matthew Bobrow](#)**

212.940.3730

[mbobrow@nixonpeabody.com](mailto:mbobrow@nixonpeabody.com)

---