CLIENT ALERT

The SEC's Proposed Rules Creates Both New Obligations and Prohibitions for Private Fund Advisers

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Introduction

On February 9, 2022, the U.S. Securities and Exchange Commission (the "SEC") proposed new rules and amendments under the U.S. Investment Advisers Act of 1940, as amended, which would significantly impact both SEC-registered private fund advisers, as well as private fund advisers that are not SEC-registered (including exempt reporting advisers). The SEC stated that the purpose of the proposed rules and amendments is to protect private fund investors as well as the companies that raise capital from private funds. In particular, the SEC noted that the proposed rules and amendments were designed to combat the negative trends in the $18 trillion-dollar private fund industry that the SEC identified, including "opaque" business practices, a lack of "sufficient transparency," and conflicts of interest in business dealings.

The proposed rules and amendments would create both affirmative obligations and prohibitions for private fund advisers. The affirmative obligations would only apply to private fund advisers that are registered with the SEC, but the prohibitions would apply to all private fund advisers, regardless of whether they are SEC-registered. This Client Alert summarizes the new affirmative obligations and the prohibitions that would apply to private fund advisers under the proposed rules and amendments.

Affirmative Obligations for SEC-Registered Private Fund Advisers

The proposed rules and amendments would require private fund advisers that are SEC-registered investment advisers to comply with the following new requirements and obligations, which significantly expand the information provided to private fund investors:

- *Distribution of Quarterly Statements*. SEC-registered private fund advisers would be required to distribute quarterly statements to private fund investors, within 45 days after the end of each quarter, which contain information regarding (i) the compensation paid to the private fund adviser (or its affiliates), (ii) a detailed accounting and calculation of the fees and expenses paid by the private fund during the period, and (iii) the private fund's performance for (A) liquid funds (e.g., the liquid fund's annual net total returns for each calendar year since inception, the liquid fund's average annual net total returns over one, five and ten-calendar year periods, and the liquid fund's quarterly net total returns for the current calendar year) and/or (B) illiquid funds (e.g., the illiquid fund's gross and net internal rate of return and the illiquid fund's gross and net multiple of invested capital, in each case, since inception through the end of the current calendar quarter), as applicable. Each quarterly statement must include a prominent disclosure regarding how the expenses, payments, allocations, rebates, waivers, and offsets, if any, are calculated, and include cross references to the relevant section of the private fund's organizational and offering documents.

- *Subjecting the Private Funds to Mandatory Audits.* SEC-registered private fund advisers would be required to obtain audited financial statements of the private funds they manage on an annual basis and upon the liquidation of a private fund. The audit must be performed by an independent public accountant, must be prepared in accordance with US GAAP (or the equivalent for non-US funds) and the auditor would be required to notify the SEC of certain events (e.g., termination of the auditor's engagement).
- *Obligations related to Adviser-Led Secondary Transactions*. SEC-registered private fund advisers would be required to obtain a fairness opinion in connection with certain "adviser-led secondary transactions" (i.e., transactions where a private fund adviser offers the private fund investors the choice to sell all or a portion of their respective interests in the private fund, or convert or exchange all or a portion of their respective interest in the private fund for interests in another vehicle advised by the adviser or any of its related persons). The fairness opinion must be issued by an "independent opinion provider" that provides fairness opinions in the ordinary course of business and is not related to the private fund adviser. The private fund adviser must also distribute to investors a summary of any material business relationships the adviser has had within the past two years with the independent opinion provider.
- *Additional Recordkeeping Obligations; Annual Review*. SEC-registered private fund advisers would be required to retain books and records related to the new obligations under the proposed rules and amendments, including the quarterly statements distributed to private fund investors (e.g., all records evidencing how calculations were made) and all records necessary to support their compliance with the proposed adviser-led secondaries rule (e.g., copies of the fairness opinion and material business relationship summary). In addition, SEC-registered private fund advisers would be required to document the annual review of their compliance policies.

Prohibitions Applicable to all Private Fund Advisers

The proposed rules and amendments would also prohibit both private fund advisers that are SEC-registered investment advisers, as well as private fund advisers that are not registered with the SEC (including exempt reporting advisers), from engaging in the following activities, many of which are currently permitted with appropriate disclosure:

- *Providing Certain Types of Preferential Treatment to Investors*. All private fund advisers would be prohibited from providing preferential treatment to certain investors regarding redemptions/withdrawals or information about portfolio holdings or exposures. Additionally, private fund advisers must sufficiently disclose to investors the types of preferential treatment afforded to investors and potential investors within the private fund, including a description of any lower fee terms.
- *Charging Fees for Unperformed Services*. All private fund advisers would be prohibited from charging a portfolio investment (i.e., a portfolio company of a private fund) fees for monitoring, servicing, consulting or other services that the private fund adviser does not, or does not reasonably expect to, provide.
- *Charging Fees and Expenses related to Regulatory Examinations and Compliance*. All private fund advisers would be prohibited from charging a private fund (i) the fees or expenses associated with any examination or investigation of the adviser or its affiliates by a governmental or regulatory authority, and/or (ii) the regulatory and compliance fees and expenses of the private fund adviser. However, private fund advisers may still charge a private fund for all of the costs associated with the private fund's regulatory filings, such as a Form D.
- *Charging Fees or Allocating Expenses on a Non-Pro Rata Basis*. All private fund advisers would be prohibited from directly or indirectly 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.

- *Reducing Adviser Clawbacks for Taxes*. All private fund advisers would be prohibited from reducing the amount of any "clawback" (i.e., any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation pursuant to a private fund's governing documents) by actual, potential or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.
- *Limiting or Eliminating Liability for Adviser Misconduct*. All private fund advisers would be prohibited from, directly or indirectly, 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 a private fund.
- *Borrowing from Clients*. All private fund advisers would be prohibited from directly or indirectly borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund.

Conclusion

If adopted, the SEC's proposed rules and amendments would have a material impact on private fund advisers, regardless of whether they are SEC-registered investment advisers, and significantly increase the compliance costs to, and risks of doing business as, private fund advisers. Moreover, the rules and amendments would change long standing, negotiated market practices applicable to private fund advisers.

The SEC has opened a comment period on these affirmative obligations and whether the prohibited practices should be permitted, until 30 days after the date of publication in the federal register or April 11, 2022, whichever is later. Additionally, if the rules are adopted, the SEC has proposed a one-year transition period to provide time for advisers to come into compliance with these new and amended rules. Winston & Strawn is closely monitoring this development and expects significant pushback by the private funds industry. We will provide our clients and friends of the firm with more information on this issue as it becomes available.

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