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Client Alert Commentary

Latham & Watkins Investment Funds Practice

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SEC Proposes Significant Rule Changes for Private Fund Advisers

The proposed amendments will have a substantial regulatory impact on private fund managers if adopted.

On February 9, 2022, the Securities and Exchange Commission (SEC) published a proposed rule that, if adopted, would modify the regulation of private fund advisers. The proposed rules would:

- Require registered private fund advisers to provide investors with quarterly statements detailing certain private fund information;
- Require registered private fund advisers to obtain an annual audit for each private fund;
- Require registered private fund advisers, in connection with an adviser-led secondary transaction, to obtain and distribute a fairness opinion to investors;
- Prohibit all private fund advisers from engaging in certain enumerated activities and practices;
- Prohibit all private fund advisers from providing certain types of preferential treatment and prohibiting all other types of preferential treatment unless disclosed to current and prospective investors; and
- Require all registered advisers, including those that do not advise private funds, to document the annual review of their compliance policies and procedures in writing.

Registered Private Fund Advisers

Quarterly Statements

The proposal would require registered private fund advisers to prepare and distribute a quarterly statement that includes specified information regarding fees, expenses, and performance for any private fund it advises, and to distribute the quarterly statement to such fund's investors within 45 days after each calendar quarter-end. The proposed rule provides an exception for advisers if a quarterly statement that complies with the proposed rule is prepared and distributed by another person.

Fees and Expenses. The proposed rule would require such statement to include the following in table format:

- A detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the private fund during the reporting period;

- A detailed accounting of all fees and expenses paid by the private fund during the reporting period, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses; and

- Disclosure of the dollar amount of each category of adviser compensation and fund expenses before and after any reduction for offsets, rebates or waivers for the reporting period.

Portfolio Investment-Level Disclosure. The proposed rule would require such statement to include the following in table format:

- A detailed accounting of all portfolio investment compensation allocated or paid by each "covered portfolio investment"[1] during the reporting period, including origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees, or similar fees or payments by the covered portfolio investment to the investment adviser or any of its related persons; and

- The private fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period.

Calculations and Cross References to Organizational and Offering Documents. The proposed rule would require each quarterly statement to include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated, as well as cross references to the relevant sections of the private fund's organizational and offering documents that set forth such calculation methodology.

Performance Disclosure. The proposal also would require each quarterly statement to provide standardized information regarding the private fund's performance.

- For liquid funds,[2] the statement would provide annual net total returns since inception, average annual net total returns over prescribed time periods, and quarterly net total returns for the current calendar year.

- For illiquid funds, the statement would provide the gross and net internal rate of return and gross and net multiple of invested capital for the illiquid fund, as well as the gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately. The proposed rule also would require advisers to provide investors with a statement of contributions and distributions for the illiquid fund.

The different categories of required performance information in the quarterly statement must be displayed with equal prominence.

Private Fund Audit

The proposal would require registered private fund advisers to obtain an annual audit of the financial statements of the private funds they advise, as well as an audit upon an entity's liquidation. The proposal would also require the audited financial statements to be distributed to investors promptly after completion of the audit.

Additionally, the proposal would require the auditor to notify the SEC upon certain events. Advisers must enter into, or cause the private fund to enter into, a written agreement with the independent public accountant performing the audit to notify the SEC (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. The accountant making such a notification would be required to provide its contact information and indicate its reason for sending the notification. The SEC has noted that such information will help inform the need for an examination of the adviser.

The SEC noted that the proposed audit rule is based on the custody rule and contains many similar or identical requirements, although compliance with either rule would not automatically satisfy the requirements of the other. Most notably, there are several ways an adviser may comply with the custody rule under the current rule; by contrast, the proposed rule requires advisers to obtain an audit.[3]

Adviser-Led Secondaries

The proposal would require a registered private fund adviser to obtain a fairness opinion in connection with an adviser-led secondary transaction. In adviser-led secondary transactions, advisers may offer existing fund investors the option to sell or exchange their interests in the fund for interests in another vehicle advised by the adviser. Pursuant to the proposed rule, an independent opinion provider[4] would opine on the fairness of the price being offered to the private fund investors for any assets being sold as part of the transaction. Moreover, the proposal would require the adviser to prepare and distribute to such investors a summary of any material business relationships the independent opinion provider has or has had within the past two years with the adviser or any of its related persons.

All Private Fund Advisers

Prohibited Activities

The proposal would prohibit all private fund advisers — regardless of whether they are registered with the SEC or are exempt reporting advisers or unregistered advisers — from engaging in the following activities and practices:

- Charging certain fees and expenses to a private fund or its portfolio investments, such as fees for unperformed services (e.g., accelerated monitoring fees) and fees associated with an examination or investigation of the adviser;
- Charging fees or expenses related to a portfolio investment on a non-*pro rata* basis;
- Reducing the amount of an adviser clawback by the amount of certain taxes;
- Seeking reimbursement, indemnification, exculpation, or limitation of its liability for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund; and

- Borrowing or receiving an extension of credit from a private fund client.

Preferential Treatment

The proposed rule would prohibit all private fund advisers — regardless of whether they are registered with the SEC or are exempt reporting advisers or unregistered advisers — from providing preferential terms to certain investors regarding redemptions from the fund or information about portfolio holdings or exposures. The proposed rule would extend this prohibition to investors in a "substantially similar pool of assets" (*e.g.*, certain custom feeder funds created for favored investors). It also would prohibit all private fund advisers from providing other preferential treatment unless disclosed to current and prospective investors. The proposed rule states that whether terms are preferential would depend on the facts and circumstances.

All Registered Advisers

Books and Records Rule Amendments

The proposal includes amendments to the books and records rule under the Investment Advisers Act of 1940 (the Advisers Act) that require advisers to retain records related to the proposed rules. The amendments would facilitate the SEC's ability to assess an adviser's compliance with the proposed rules.

Compliance Rule Amendments

The proposal includes amendments to the compliance rule under the Advisers Act that require all registered advisers, including those that do not advise private funds, to document their annual review in writing.

Conclusion

If adopted, the proposed rule would substantially increase the compliance burden of registered advisers and outright prohibit certain practices of registered and unregistered advisers.

The proposed rule will be open for comment for a 30-day period upon publication in the Federal Register or April 11, 2022, whichever date is later.

Latham & Watkins will continue to monitor and provide updates on details regarding the proposed rules.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

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Endnotes

[1] The proposed rule defines a "covered portfolio investment" as a portfolio investment that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period.

[2] The proposed definition for a "liquid fund" is any private fund that is not an illiquid fund. The proposed rule defines an "illiquid fund" as a private fund that: (i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor's request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments.

[3] Under the custody rule, an adviser is deemed to have satisfied that rule's annual surprise examination requirement for a pooled investment vehicle client if that pool is subject to an annual financial statement audit by an independent public accountant, and its audited financial statements (prepared in accordance with generally accepted accounting principles) are distributed to the pool's investors within 120 days of the adviser's fiscal year end.

[4] The proposed definition for an "independent opinion provider" is one that (i) provides fairness opinions in the ordinary course of its business and (ii) is not a related person of the adviser.