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Private Equity Regulatory Update - January 2022

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In this issue, we discuss the SEC's proposed amendments to Form PF, SEC staff observations regarding Form CRS compliance and examinations of private fund advisers, and a recent enforcement action involving a private fund manager and certain fee and expense disclosure failures.

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Rules and regulations

SEC proposes amendments to bolster private fund reporting

On January 26, 2022, the Securities and Exchange Commission (SEC) voted to propose certain amendments to Form PF designed to facilitate the SEC's oversight of private fund advisers and bolster its investor protection efforts. The proposed amendments are also designed to enhance the Financial Stability Oversight Council's ability to monitor and assess systemic risks presented by the private fund industry. See our client alert highlighting the key elements of the proposed amendments.

Industry update

SEC statement regarding Form CRS disclosures

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On December 17, 2021, the SEC Standards of Conduct Implementation Committee (the Committee) published a statement outlining its observations regarding compliance with Form CRS requirements. SEC-registered broker-dealers and investment advisers (firms) that offer services to retail investors must file with the SEC and provide to retail investors relationship summaries on Form CRS designed to allow retail investors to make informed decisions about whether a brokerage or investment advisory relationship (or a combination of the two) best suits their particular circumstances and investment objectives.

As the Committee has been evaluating whether the relationship summary is fulfilling its intended purpose – "to promote transparency, comparability and better-informed decision-making, through clear, concise disclosures, and by summarizing in one place selected information about a particular firm" – it has shared its observations as to the areas in which compliance improvements are most needed, encouraging firms to review their relationship summaries in light of such observations.

- Use of technical language, including disclaimers – In conflict with the requirement that language must be concise and in plain English, take into account retail investors' level of financial experience and not include any disclosure other than what is required or permitted by Form CRS' instructions, the Committee noted that some firms were using terms like "riskless principal," "in arrears," "markups" and "markdowns," citing to specific SEC rules without explaining them, using legal jargon and using impermissible hedging language.
- Omission of required information – The Committee observed that some firms omitted required disclosures, such as headers, prescribed language or conversation starters, in areas including conflicts of interest, monitoring services, investment authority and disciplinary history in violation of the standard that firms may only omit or modify a required disclosure or conversation starter where (1) it is inapplicable to the firm's business or (2) the specific wording the form requires would be inaccurate with respect to the firm.
- Reliance on proposed, rather than final instructions – The Committee noted that some firms were relying on the proposed, rather than the final, instructions to Form CRS, emphasizing that all firms should rely only on the adopted final instructions.
- Lack of specific references to more detailed information – In connection with the requirement that firms include specific references to detailed information regarding their services, fees and costs and conflicts of interest, the Committee observed that while some firms cited to their Form ADV Part 2A and a "Regulation Best Interest Disclosure," they did not provide a ready means of accessing that information, such as a hyperlink embedded in the relationship summary, even though the materials were available online. The Committee further noted that other firms did not include the required references at all.
- Shortcomings in descriptions of relationships and services; fees, costs, conflicts and standards of conduct – The Committee observed failures to include required information, as well as the inclusion of impermissible, extraneous or unresponsive disclosures, primarily in the following categories of the relationship summaries:
  - **Monitoring**: some firms did not comply with requirements to explain whether they monitor retail investors' investments and if so, whether the monitoring services are included in the firm's standard services, as well as the frequency and any material limitations on the firm's monitoring.
  - **Investment authority**: some relationship summaries failed to describe the firm's investment authority, such that retail investors may not understand who – the firm or the retail investor – makes the ultimate decision to purchase or sell an investment. Other summaries that stated the firm exercised both discretionary and non-discretionary authority failed to make clear which investment authority applied to which of the firm's services or accounts.
  - **Limited investment offerings**: some firms failed to expressly disclose whether they had any product limitations or, if they did disclose such limitations, failed to appropriately describe them, as is required. A product limitation may include a firm only making available or offering advice on proprietary products or limited types of products or investments.
  - **Principal fees and costs**: some relationship summaries failed to include specific fee descriptions or did not cover the frequency and the basis on which fees were assessed and billed. Others failed to mention the conflicts of interest or incentives associated with the disclosed fees.
  - **Wrap fee program offerings and fees**: some firms that offered wrap fee programs did not describe the program's services, fees and costs, as required.
  - **Extraneous disclosures regarding standards of conduct**: some firms used terms such as "fiduciaries" and "fiduciary duty" when referring to themselves and the applicable standard of conduct rather than using the prescribed language including the term "best interest."

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- **Firm and financial professional compensation arrangements and conflicts of interest**: the Committee highlighted as helpful some firms' conflicts disclosures that provided specific examples to help investors understand incentives arising in particular contexts. In contrast, improper conflicts disclosure included vague language, failure to explain when the conflict could arise, and an emphasis on mitigating the conflicts through the firm's standard of conduct.

- Modification and/or supplementation of the disciplinary history disclosure – The Committee highlighted that relationship summaries must include the heading "Do you or your financial professionals have legal or disciplinary history?" and that the firm must provide a "yes" or "no" answer, refer to Investor.gov/CRS and include the required conversation starters. The Committee reminded firms that they are not permitted to leave the disciplinary history blank, omit reportable disciplinary history or add descriptive language in their responses to this item.
- Issues with prominently displaying relationship summary on firm website – In connection with the requirement that all firms operating a publicly available website post the current version of their relationship summary prominently on that website, the Committee observed some firms using small or difficult to read text in the relationship summary's hyperlink or locating the hyperlink several clicks away from the investor homepage, labeling the relationship summary with a non-descriptive term or placing it among several other disclosure and/or promotional documents.
- Issues with description of affiliate relationships – The Committee noted that some affiliated firms that prepared a single relationship summary failed to clearly delineate which firm offered which services or products and which disclosures related to which firm. Further, some firms listed numerous affiliated entities without describing the relationships among them.
- Poor design – The Committee emphasized its expectation that firms use white space and certain required text features and encouraged firms to use charts, graphs, tables, etc. to make information more digestible to retail investors.
- Use of marketing language – The Committee observed some firms using marketing language, touting firms' abilities and using superlatives such as being held to the "highest possible legal standard," in violation of the requirement that responses be factual, balanced and not exaggerated.
- Boilerplate – The Committee observed some firms using boilerplate language that appeared to the Committee to have been based on a summary template without appropriate tailoring.

In light of these observations, the Committee encouraged firms to review Form CRS' specific requirements and contact the SEC with any interpretive questions.

SEC names William A. Birdthistle as Director of the Division of Investment Management

On December 21, 2021, the SEC announced the appointment of William A. Birdthistle as Director of the Division of Investment Management. Currently a professor at Chicago-Kent College of Law, Birdthistle's research focuses on investment funds, securities regulation and corporate governance. Birdthistle will replace Sarah ten Siethoff, who has served as Acting Director since January 2021.

SEC Division of Examinations' observations from examinations of private fund advisers

On January 27, 2022, the SEC Division of Examinations (EXAMS) published a Risk Alert highlighting its observations of compliance shortcomings by registered investment advisers that manage private funds (private fund advisers).

This Risk Alert followed up on a prior Risk Alert EXAMS published on June 23, 2020 on the topic and focused on four categories of compliance issues observed among private fund advisers: (1) conduct inconsistent with disclosures; (2) use of misleading performance and marketing disclosures; (3) due diligence failures and (4) use of potentially misleading hedge clauses. EXAMS encouraged private fund advisers to review and enhance their compliance programs in light of these observations.

Conduct inconsistent with disclosures. EXAMS staff observed private fund advisers failing to act in accordance with material disclosures they had made to clients or investors in the following areas:

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- Failure to obtain informed consent from Limited Partner Advisory Committees, Advisory Boards or Advisory Committees (collectively LPACs) as required by applicable limited partnership agreements (LPAs), operating agreements, private placement memoranda, side letters or other disclosures (collectively fund disclosures) – EXAMS staff observed some private fund advisers failing to submit conflicts to their LPACs for review and consent, submitting them only after the transaction had occurred, or obtaining consent after providing the LPAC with incomplete information, in each case in violation of fund disclosures.
- Failure to follow practices outlined in fund disclosures regarding the calculation of Post-Commitment Period fund-level management fees – EXAMS staff observed private fund advisers failing to follow their disclosed practices when calculating the fund-level management fee during the private fund's Post-Commitment Period, resulting in higher fees than investors were required to pay under the fund disclosures. Examples included private fund advisers using broad, undefined terms in fund LPAs (e.g., "impaired", "permanently impaired", "written down", and "permanently written down") that were not consistently applied, as well as failing to reduce the cost basis of an investment after disposing of a portion of it.
- Failure to comply with LPA liquidation and fund extension terms – EXAMS staff observed private fund advisers failing to obtain the required approvals or comply with the applicable LPA liquidation provisions prior to extending a private equity fund's term, resulting in potentially improper management fees.
- Failure to invest in accordance with fund disclosures regarding investment strategy – EXAMS staff observed private fund advisors implementing investment strategies that were materially different from those described in fund disclosures as well as exceeding disclosed leverage limitations.
- Failures relating to recycling practices – EXAMS staff observed deficiencies in private fund advisers' descriptions of funds' abilities to add realized investment proceeds back to the capital commitments of investors (recycling), which, EXAMS staff noted, could result in the collection of excess management fees.

Failure to follow fund disclosures regarding adviser personnel – EXAMS staff noted private fund advisers' failure to adhere to the "key person" process outlined in the fund's LPA.

Disclosures regarding performance and marketing. EXAMS staff observed private fund advisers providing misleading marketing statements to investors and prospective investors in contravention of Rule 206(4)-8 of the Advisers Act. It also noted deficiencies in the maintenance of the underlying materials used to form the basis for, or demonstrate the calculation of, performance or rate of return of managed accounts or securities recommendations.

- Misleading material information about a track record – EXAMS staff observed inaccurate or misleading disclosures about advisers' track records, such as marketing only a "cherry-picked" track record of one fund or subset of funds, failing to disclose material information about the impact of leverage on performance, presenting outdated performance information and failing to accurately show fees and expenses.
- Inaccurate performance calculations – EXAMS staff observed private fund advisers using inaccurate data to create track records, such as relying on projected rather than actual performance, using data from the wrong time periods and improperly treating return of capital distributions as portfolio company dividends.
- Failure to adequately support, or omissions of material information about, predecessor performance – EXAMS staff observed private fund advisers' failures to maintain books and records supporting predecessor performance at other advisers as required by Rule 204-2(a)(16). It also noted omissions of material facts, such as marketing incomplete prior track records or failing to disclose where relevant persons were not primarily responsible for the marketed performance.
- Misleading statements regarding awards or other claims – EXAMS staff observed private fund advisers advertising awards received without disclosing the criteria for obtaining them or any amounts paid by the adviser to receive them and/or to advertise its receipt of them. EXAMS staff also observed inaccurate claims that advisers' investments were "supported" or "overseen" by the SEC or the United States government.

Due diligence. In violation of Rule 206(4)-7 of the Advisers Act (the Compliance Rule) EXAMS staff observed failures in the due diligence process.

- Lack of a reasonable investigation into underlying investments or funds – EXAMS staff observed failures to perform reasonable investigations of investments, including of the compliance and internal controls of the underlying investments or private funds in which they invested, as well as of key service providers.
- Inadequate policies and procedures regarding investment due diligence – EXAMS staff observed private fund advisers' failures to maintain reasonably designed policies and procedure, including those tailored to their advisory business.

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Hedge clauses. In contravention of Sections 206 and 215(a) of the Advisers Act, EXAMS staff observed private fund advisers using hedge clauses in documents to purportedly limit or waive the fiduciary duty imposed by the Advisers Act except in certain circumstances, such as a non-appealable judicial finding of gross negligence, willful misconduct or fraud.

Litigation

SEC settles with investment adviser for alleged failure to properly offset management fees

On December 20, 2021, the SEC issued an order (Global Order or Order) instituting and settling administrative proceedings against Global Infrastructure Management, LLC (Global), a registered investment adviser with assets under management of approximately $77 billion, for certain alleged failures relating management fee offsets.

According to the Global Order, the private placement memoranda (PPMs) and Limited Partnership Agreements (LPAs) for two Global-managed private equity funds (Fund I and Fund III) stated that Global would offset advisory fees that Global received against fund-level management fees otherwise payable by limited partners. The SEC alleges that due to "deficiencies in [Global]'s compliance program," such as failing to have written policies and procedures to confirm the accuracy of fee offsets, certain advisory fees received from a portfolio company of Fund I were not properly offset. Similarly, the SEC alleges that certain director fees received on account of a portfolio company of Fund III were not offset.

The Global Order also states that the PPMs and LPAs for Fund I and a second fund, Fund II, did not consistently and accurately describe the calculation of management fees. According to the SEC, the PPMs for Fund I and Fund II each stated that in the event of a partial disposition of investments in a portfolio company, management fees would be charged based on the fund's remaining interest in the company. The SEC alleges that the LPAs for Fund I and Fund II provided that management fees would be calculated based upon limited partners' capital contributions used to fund an investment and, accordingly, would not be reduced on account of a partial disposition. These inconsistent disclosures allegedly led Global to provide inconsistent responses to investors' inquires about offsets; allegedly, Global informed one investor that partial dispositions would reduce management fees and told others investors that partial dispositions would not reduce management fees. Global allegedly did not reduce fees on account of partial dispositions; this was consistent with the LPAs, but not consistent with the disclosures in the PPMs.

Global later reviewed the effects of these alleged failures on its investors, and voluntarily provided a total of approximately $5.4 million, plus interest, in remediation to affected limited partners of the Funds. Global also enhanced disclosures and improved procedures and controls relating to the calculation of fee offsets.

On account of the alleged disclosure and compliance failures, Global allegedly violated Section 206(2) and 206(4) of the Advisers Act, and Rules 206(4)-8 and 206(4)-7 thereunder. In addition to the voluntary remediation described above, Global agreed to be cease and desist from further violations, to be censured, and to pay civil penalty of $4.5 million.

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