Davis Polk

SEC proposes new rules and amendments to enhance private fund investor protections

February 10, 2022 | Client Update | 5-minute read

The SEC's proposed new rules and amendments include new requirements related to quarterly statements, private fund audits, adviser-led secondaries, prohibited activities, preferential treatment and annual reviews under Rule 206(4)-7.

On February 9, 2022, the Securities and Exchange Commission (SEC) voted to propose new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act). The SEC's proposal is designed to enhance the regulation of private fund advisers, increase investors' visibility into certain adviser practices and address adviser practices that can potentially lead to investor harm. The primary elements of the proposed amendments include:

- **Quarterly statements**
  Within 45 days after each calendar quarter end, registered private fund advisers would be required to circulate a quarterly statement to private fund investors, including the following:
  - **Fees and expenses:** Advisers would need to disclose the following information in a 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 (e.g., management, advisory, subadvisory or similar fees or payments, and performance-based compensation)
    - A detailed accounting of all fund fees and expenses paid by the private fund during the reporting period (e.g., organizational, accounting, legal, administration, audit, tax, due diligence and travel expenses)
    - The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons
  - **Portfolio investment-level disclosure:** Advisers would need to disclose the following information in a table format:
    - A detailed accounting of all portfolio investment compensation allocated or paid by each "covered portfolio investment" 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
    - 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:** Advisers would need to provide 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 the calculation methodology.
  - **Performance disclosure:** Advisers would need to include standardized performance, including prominent disclosure of the criteria used and assumptions made in calculating the performance; the SEC has proposed a

different approach for liquid and illiquid funds:

  - An adviser to a liquid fund (as defined in the proposed rule) would need to show performance based on net total return on an annual basis since the fund's inception, over prescribed time periods and on a quarterly basis for the current year.
  - An adviser to an illiquid fund (as defined in the proposed rule) would need to show performance based on the internal rate of return and a multiple of invested capital (computed without the impact of any fund-level subscription facilities).
  - The SEC expressed its view that subscription facilities have the potential to increase performance metrics artificially.

- **Private fund audits**
  Under the proposed rule, registered advisers to private funds (including subadvisers) would need to cause the private funds to undergo an audit by an independent public accountant at least annually and upon liquidation. The audited financial statements would need to be distributed to investors "promptly" following completion of the audit. The SEC did not provide a specific definition of "promptly" for these purposes.
- **Adviser-led secondaries**
  Registered private fund advisers would need to obtain a fairness opinion from an independent opinion provider in connection with certain adviser-led secondary transactions where such adviser offers fund investors the option (i) to sell their interests in the private fund or (ii) to exchange them for new interests in another vehicle advised by the adviser. The fairness opinion would need to be distributed to investors in the private fund prior to the closing of the transaction.
- **Prohibited activities**
  This proposal would prohibit private fund advisers from engaging in certain activities and practices that are "contrary to the public interest and the protection of investors," including:
  - Charging certain fees and expenses to a private fund or portfolio investment, including accelerated monitoring fees; fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities; regulatory or compliance expenses or fees of the adviser or its related persons; or fees and expenses related to a 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 the amount of any adviser clawback by the amount of certain taxes
  - 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
  - Borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client
- **Preferential treatment/side letters**
  Private fund advisers would not be permitted to provide preferential terms to certain investors regarding redemptions or information about portfolio holdings or exposures (e.g., through side letters); this provision would also apply with respect to investors in a "substantially similar pool of assets." Private fund advisers would also be prohibited from providing other preferential terms unless the adviser disclosed such terms in writing to current and prospective investors.
- **Books and records**
  The proposal would amend the books and records rule under the Advisers Act to require advisers to retain records related to the proposed rules.
- **Compliance rule**
  The proposal would amend the compliance rule under the Advisers Act such that all SEC-registered investment advisers would be required to document their annual review in writing. The SEC did not prescribe any elements regarding what must be a part of the written review and intends for advisers to have flexibility with respect to how they satisfy this requirement.

The comment period will remain open until April 11, 2022. If the proposed amendments are adopted, they would have a significant impact on the disclosure and compliance obligations of private fund advisers.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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