Davis Polk

Private Equity Regulatory Update - February 2022

February 28, 2022 | Client Update | 16-minute read

In this issue, we discuss recent SEC proposals relating to Form PF, cybersecurity and requirements for private fund advisers, as well as recent enforcement actions involving "hedge clauses" and compliance failures with respect to advertisements.

Rules and regulations
SEC proposes expanded cyber oversight after Gensler signals more on the way
SEC proposes new rules and amendments to enhance private fund investor protections
SEC proposes amendments to bolster private fund reporting

Litigation
SEC settles with investment adviser for alleged "hedge clause" violations, failure to disclose conflicts of interest
SEC settles with investment adviser for its alleged books and records and compliance failures relating to advertisements

Rules and regulations

SEC proposes expanded cyber oversight after Gensler signals more on the way

The Securities and Exchange Commission (SEC) proposed new cybersecurity rules for investment advisers and investment companies that would require policies and procedures, annual reviews, reporting to the SEC, disclosures to investors, and recordkeeping. The rules would subject investment advisers and investment companies to increased enforcement risk. Please see Davis Polk's client update for further information on the proposal.

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

Copyright 2022 Davis Polk & Wardwell LLP

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. Please see Davis Polk's client update for further information on the proposal.

SEC proposes amendments to bolster private fund reporting

Summary

In a January 26, 2022 release (Proposing Release), the SEC proposed to amend Form PF, the confidential reporting form used by certain SEC-registered investment advisers to report information about the private funds they advise. If adopted, the proposal would (i) impose current reporting requirements for large hedge fund advisers and advisers to private equity funds within one business day of certain significant events, (ii) lower the reporting threshold for large private equity advisers and revise their reporting requirements, and (iii) require large liquidity fund advisers to report substantially the same information that money market funds would report on Form N-MFP, as recently proposed by the SEC. The proposed amendments are designed to facilitate the SEC's oversight of private fund advisers and enhance its investor protection efforts. They are also intended to improve the Financial Stability Oversight Council's (FSOC)'s ability to monitor and assess systemic risks presented by the private fund industry.

The comment period for the proposal will remain open until March 21, 2022. This comment period is shorter in comparison to what is generally seen in connection with SEC rule proposals, meaning that private fund managers will have a more limited window during which they can engage with the SEC on the proposal. If the proposed amendments are adopted, private funds in the United States would face significant changes in both the scope and frequency of their reporting obligations on Form PF.

Key takeaways

The proposals contained in the Proposing Release are discussed in greater detail below. Some key takeaways of the proposal include:

- New current reporting obligations for large hedge fund advisers and advisers to private equity funds that would obligate them to report occurrence of certain events within one business day;
- Lowered reporting threshold for large private equity advisers and modifications to section 4 of Form PF to require disclosure of additional information about the funds they advise;
- Increased reporting obligations for large liquidity fund advisers, who would be required to report substantially the same information that money market funds would report on Form N-MFP, as recently proposed by the SEC.

Background

Adopted in 2011, Form PF is a confidential report which certain SEC-registered investment advisers are required to file periodically with the SEC to report information about the private funds they advise. The information collected on Form PF reveals the basic operations and strategies of private funds and has helped establish a baseline picture of the industry to assist the SEC and FSOC with monitoring systemic risk in the U.S. financial market. However, as Chair Gensler noted in his statement supporting the Proposing Release, the private fund industry has undergone tremendous changes since the initial adoption of Form PF. Not only did the industry grow in size to a net asset value of $11 trillion, it also evolved in terms of "business practices, complexity of fund structures, and investment strategies and exposures."[1] In light of these developments, Chair Gensler noted in his statement that the SEC believes that the current Form PF regime may fall short of obtaining more timely and comprehensive data that would enable it and FSOC to better understand the private fund industry and adopt more appropriate regulatory responses. The proposed amendments are thus designed to strengthen FSOC's ability to monitor and assess the potential systemic risk presented by the industry and to provide additional data for FSOC's use in deploying its regulatory tools. In addition, the proposed amendments would collect additional information for the SEC's use in its regulatory programs, including examinations, investigations and investor protection efforts relating to private fund advisers.

New current reporting obligations for large hedge fund advisers and advisers to private equity funds

Under the proposed amendments, large hedge fund advisers would be required to file a current report on a new section 5 within one business day of the occurrence of one of several reporting events at a qualifying hedge fund that they advise. The new section 5 would require advisers to provide certain identifying information about themselves and the reporting funds and use check boxes to describe the event(s) reported. In addition, advisers would have the option to provide an explanatory note relating to circumstances surrounding the reporting event. The Proposing Release noted the following events that would trigger this current reporting obligation:

Copyright 2022 Davis Polk & Wardwell LLP

- Extraordinary investment losses, meaning a fund’s cumulative loss that is equal to or is greater than 20% of the fund’s most recent net asset value over a rolling 10-business-day period.
- Significant margin and default events, including:
  - A cumulative increase in the fund’s requirements for margin, collateral, or an equivalent when such increase is more than 20% of the fund’s most recent net asset value over a rolling 10-business-day period;
  - A margin default by the fund or an inability to meet a call for margin, collateral, or an equivalent, including situations where there is a dispute with regard to the amount or appropriateness of the margin call;
  - A margin default by a counterparty if such counterparty (i) does not meet a call for margin or has failed to make any other payment, in the time and form contractually required, and (ii) the amount involved exceeds 5% of the most recent net asset value of the fund.
- Material change in relationship with prime broker, e.g., material changes to the fund’s ability to trade, termination of prime brokerage relationship.
- Changes in unencumbered cash, when the value of the fund’s unencumbered cash declines by more than 20% of the fund’s most recent net asset value over a rolling 10-trading-day period.
- Operations events that constitute a “significant disruption or degradation” of the fund’s key operations. According to the Proposing Release, “key operations” means operations necessary for (i) the investment, trading, valuation, reporting, and risk management of the reporting fund; as well as (ii) the operation of the reporting fund in accordance with the Federal securities laws and regulations. Under the proposal, “significant disruption or degradation” is defined as, for operations events that are reasonably measurable, a 20 percent disruption or degradation of normal volume or capacity. For instance, a cybersecurity event that disrupted the trading volume of a reporting fund by 20 percent of its normal capacity would trigger its adviser’s reporting obligation.
- Withdrawals and redemptions, when the cumulative requests for redemption received by the adviser exceed 50% of the most recent net asset value of the fund.
- Inability to satisfy redemptions or a suspension of redemptions for more than five consecutive business days.

In addition, the proposed amendments would obligate all private equity advisers to use a new section 6 on Form PF to file a current report within one business day of the occurrence of certain significant events. Similar to the new section 5, section 6 would require advisers to report certain identifying information about themselves and the reporting funds, and describe the event(s) reported using checkboxes. The new section 6 also provides the flexibility for advisers to add notes explaining the context surrounding the reporting event. According to the Proposing Release, the following events would need to be reported on the new section 6:

- The completion of an adviser-led secondary transaction, which is defined as any transaction initiated by the adviser or any of its related persons that offers private fund investors the choice to: (1) sell all or a portion of their interests in the fund; or (2) convert or exchange all or a portion of their interests in the fund for interests in another vehicle advised by the adviser or its related persons.
- Implementation of a general partner clawback. In addition, advisors would have to report the implementation of a limited partner clawback when the aggregate amount exceeds 10% of the fund’s aggregate capital commitments.
- Removal or termination events effected by the fund investors, including (1) removal of the adviser or an affiliate as the general partner of similar control person of a fund, (2) termination of the fund’s investment period, or (3) termination of the fund.

Large private equity adviser reporting change

Under the proposed amendments, the reporting threshold for large private equity advisers would be lowered from $2 billion to $1.5 billion in private equity fund assets under management.

In addition, the proposal seeks to expand the information gathered from large private equity advisers by adding a variety of items to section 4 of Form PF. The proposed items require information regarding the following:

- Question 68: Investment strategies by percent of deployed capital;
- Question 70: Restructuring/recapitalization of a portfolio company;
- Question 71: Investments in different levels of a single portfolio company’s capital structure by related funds;
- Question 72: Fund-level borrowings as an alternative or complement to the financing of portfolio companies;

Copyright 2022 Davis Polk & Wardwell LLP

- Question 74: Provision of financing or extensions of credit to a portfolio company by the adviser or its related persons;
- Question 82: Percentage of aggregate borrowings for the fund's controlled portfolio companies that are at a floating rate;
- Question 67: Number of controlled portfolio companies that the fund owns;

The Proposing Release also noted the following changes to three existing questions in section 4:

- Question 74 (redesignated as Question 83): Events of default – The revised question 74 would require private equity advisers to provide detailed information about the nature of reported events of default;
- Question 75 (redesignated as Question 84): Bridge financing to controlled portfolio companies – Under the revised question 75, private equity advisers would be required to report additional counterparty identifying information;
- Question 78 (redesignated as Question 69): Geographic breakdown of investments – The revised question 78 would require private equity advisers to report all countries to which a reporting fund has exposure of 10 percent or more of its net asset value.

Large liquidity fund adviser reporting change

Lastly, the proposed amendments would increase the reporting obligations for large liquidity fund advisers as it introduces several revisions to section 3 of Form PF. The proposed revisions would require large liquidity fund advisers to report substantially the same information that money market funds would report on Form N?MFP, as recently proposed by the SEC. The categories of information impacted by the proposal include the following:

- Operational information: The revised section 3 would require advisers to report whether the liquidity funds they advise seek to maintain a stable price per share and, if so, to provide the price they seek to maintain. However, advisers would no longer be required to report whether the liquidity fund has a policy of complying with certain provisions of rule 2a-7.
- Assets and portfolio information: Under the revised section 3, advisers would be required to report cash separately from other categories when reporting assets and portfolio information concerning repo collateral. Advisers must also report the total gross subscriptions (including dividend reinvestments) and total gross redemptions for each month of the reporting period.

In addition, the revised section 3 seeks more detailed information regarding a liquidity fund's portfolio.

- Financing information: Under the revised section 3, advisers would be required to report whether a creditor is based in the United States and, if so, whether it is a "U.S. depository institution" to align better with "the categories the Federal Reserve Board uses in its reports and analysis, to enhance systemic risk assessment."
- Investor information: The proposal requires advisers to report whether the fund is established as a cash management vehicle for other funds or accounts that the adviser or its affiliates manage that are not cash management vehicles. Additionally, advisers must disclose certain information about each investor that beneficially owns five percent or more of the reporting fund's equity.
- Disposition of portfolio securities: Under the revised section 3, advisers would be required to report information about the portfolio securities that the liquidity fund sold or disposed of during each month of the reporting period. The information required includes the amount disposed of and the category of investment.
- Weighted average maturity and weighted average life. The proposal would revise the definition of "WAM" (i.e., weighted average maturity) and "WAL" (i.e., weighted average life) so they are calculated with the dollar-weighted average based on the percentage of each security's market value in the portfolio.

Litigation

SEC settles with investment adviser for alleged "hedge clause" violations, failure to disclose conflicts of interest

On January 11, 2022, the SEC issued an order (CCM Order or the Order) instituting and settling cease-and-desist proceedings against Comprehensive Capital Management, Inc. (CCM), a New Jersey-based registered investment adviser with approximately $63 million in assets under management. CCM allegedly included a "hedge clause" in advisory agreements that purported to waive causes of action that cannot be waived under federal or state laws. CCM

Copyright 2022 Davis Polk & Wardwell LLP

also allegedly misstated in its Form ADV that certain commissions would be offset against advisory fees and failed to adequately disclose the conflict of interest created by CCM's receipt of commissions, failed to maintain certain books and records, and failed to implement its compliance policies relating to the issues identified in the Order.

CCM allegedly includes improper "hedge clauses" in advisory agreements

According to the Order, fiduciary duties that an investment adviser owes to its clients under the Advisers Act cannot be waived by contract, but their application may be shaped by agreement. Clauses in investment advisory contracts that purport to limit the adviser's liability are sometimes called "hedge clauses." The SEC has stated that hedge clauses that purport to exculpate an adviser for conduct that cannot be subject to exculpation under federal or state law may be misleading: In a June 2019 Commission Interpretation, the SEC stated that "there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with antifraud provisions, where the hedge clause purports to relieve the adviser from liability for conduct as to which the client has a non-waivable cause of action against the adviser provided by state or federal law."[2]

CCM's advisory agreements allegedly contained misleading "hedge clauses." Before June 2019, CCM's advisory agreements included a hedge clause that stated, in part:

> Client agrees to hold CCM, its officers, directors, employees, agents, independent contractors, and representatives forever harmless from *all claims*, liabilities, losses, damages, attorney's fees, costs and expenses which may arise from any act *(on Client's behalf or for Client's account), omission, or insolvency of any broker/dealer, agency, professional, independent contractor or financial products salesperson.* […]
>
> The federal securities laws impose liabilities under certain circumstances on persons who act in good faith, and therefore nothing herein shall in any way constitute a waiver or limitation of any rights which the client or CCM may have under any federal securities laws.

The SEC alleged that this "hedge clause" violates Section 206(2) of the Advisers Act because it purports to waive "all claims" for "any act." According to the CCM Order, CCM did not have "policies and procedures to assess a client's sophistication in the law or to explain the meaning of the non-waiver disclosure" and could not demonstrate that "CCM highlighted and explained the hedge clause" when appropriate. According to the Order, "there was no evidence this non-waiver disclosure would be comprehended by retail clients."

In June 2019, after the SEC issued the June 2019 interpretation described above, CCM began to use a new "hedge clause" in its advisory agreements. The revised clause provided:

> CCM and its IARs will be liable only for their own acts of gross negligence or willful misconduct. CCM and its IARs will not be liable for any act or omission, or the failure or inability to perform any obligation, of any broker, dealer, investment adviser, sub-custodian or other agent, including affiliates, whom CCM selected with reasonable care. CCM will not be liable for any incidental, indirect, special, punitive or consequential damages. Federal and state securities laws may nonetheless impose liability on persons who act in good faith and nothing in this Agreement shall serve to waive or limit any rights Client may have under those laws.

The SEC alleges that the revised hedge clause also violates Section 206(2) of the Advisers Act because it purports to relieve advisers from non-waivable causes of action under state or federal law, and because the phrase "CCM and its IARs will be liable only for their own acts of gross negligence or willful misconduct" does not accurately describe federal and state laws that could impose liability on CCM or its representatives in other circumstances.

CCM allegedly misstates commissions offset

According to the CCM Order, from 2017 through March 2021, CCM's Form ADV had misleading disclosures regarding the offset of certain commissions received. From 2017 through May 2019, CCM disclosed that commissions received from the sale of variable annuity products in IRA advisory accounts would be offset against advisory fees. However, CCM did not offset such commissions during this period.

In May 2019, CCM amended its form ADV to remove the paragraph describing the commissions offset and to add a disclosure about the conflict of interest created by the commissions. However, the SEC alleges, the disclosures misleadingly stated that the conflict of interest was mitigated because CCM's representatives would not receive commissions from the sale of products, and failed to disclose CCM's own conflict of interest. The SEC alleges that CCM improperly charged clients a total of $66,635 in commissions relating to these alleged disclosure failures.

Alleged books and records, compliance failures

Copyright 2022 Davis Polk & Wardwell LLP

The CCM Order also describes alleged books and records and compliance failures by CCM. According to the Order, CCM failed to keep true, accurate, and current records of accounts in which it was vested with discretionary power. While CCM had policies and procedures requiring that CCM maintain accurate disclosures regarding its advisory services, the SEC alleges that those policies and procedures were not implemented, and that CCM was not able to produce accurate records. In addition, CCM's compliance policies and procedures stated that "CCM advisory agreements … *do not contain any 'hedge clauses'*" (emphasis added), which was not implemented given that CCM's agreements did contain the hedge clauses described above.

Alleged violations and sanctions

On account of the conduct described above, the SEC alleged that CCM violated Sections 206(2), 206(4) and 204(a) of the Advisers Act, and Rules 206(4)-7 and 204-2(a)(8) thereunder.

CCM agreed to disgorge a total of $75,654.04 (relating to the commissions offset described above); to pay a civil money penalty of $300,000; to retain an independent compliance consultant to conduct a compliance review and make recommendations relating to, among other things, the use of hedge clauses, CCM's disclosures; to notify affected investors of the Order; and to be censured.

– CCM Order

– SEC press release

SEC settles with investment adviser for its alleged books and records and compliance failures relating to advertisements

On January 13, 2022, the SEC issued an order (CMG Order or the Order) instituting and settling cease-and-desist proceedings against CMG Capital Management Group, Inc. (CMG), a Pennsylvania-based registered investment adviser. The Order arises out of CMG's alleged failure to implement policies reasonably designed to prevent misleading advertisements relating to hypothetical, backtested performance, and alleged books and records failures.

The Order explains that CMG has been a registered investment adviser for almost 30 years and had assets under management totaling roughly $230 million as of 2021. The SEC alleges that, from April 2017 to July 2018, CMG advertised hypothetical, backtested performance results for its "Opportunistic All Asset Strategy," which is its proprietary algorithmic trading strategy, on its website and in investor "tear sheets." According to the SEC, these advertisements failed to disclose dissimilarities between the backtest and the live strategy, including the facts that "the backtest and the live strategy relied on different securities when constructing a model portfolio" and "a small number of the funds used in the backtest were not adequately correlated with the securities they replaced in the live strategy."

The SEC alleges that CMG had a written policy for compliance with SEC regulations when using performance data in marketing materials, but that CMG had not adopted or implemented procedures reasonably designed to address the risk that "the firm's advertising of hypothetical, backtested performance results would contain an untrue statement of a material fact, or be otherwise false or misleading." The Order further explains that CMG also allegedly failed to preserve copies of its "tear sheets" provided between January 2016 and June 2016.

The SEC alleges that, as a result of the conduct described above, CMG willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 for its failure to adopt and implement compliance policies and procedures reasonably designed to prevent false or misleading advertisements. The Order further alleges that CMG violated Section 204(a) of the Advisers Act and Rule 204-2(a)(11) for its failure to preserve copies of the publicly distributed "tear sheets."

The SEC considered CMG's prompt remedial actions in deciding to settle this matter, which included CMG voluntarily adopting a policy prohibiting the advertisement of hypothetical, backtested performance results. CMG agreed to cease and desist from future violations, to be censured, and to pay $70,000 in civil monetary penalties.

– CMG Order

– SEC press release

[1] SEC.gov | Statement on Form PF

[2] *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, IA Rel. No. 5248 (June 5, 2019).

Copyright 2022 Davis Polk & Wardwell LLP