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Proposed SEC Regulations Target Private Fund Advisers

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What you need to know now.

On Wednesday, February 9, 2022, the SEC proposed changes to its rules for investment advisers to private funds. The proposal, if adopted, will be a seismic shift in the regulatory landscape for private fund advisers.

We plan to share a detailed analysis soon. For now, please find below a quick Q&A update.

Q1: What is in the proposal?

A1: New requirements and prohibitions.

New Requirements

The new rules, if adopted as proposed, will **require** a private fund adviser to:

- Provide fund investors with **quarterly statements** that include standardized disclosures on fees and expenses (generated at the fund and portfolio investment levels) and investment performance (with distinct requirements for liquid and illiquid funds);
    - For purposes of calculating IRR and MOIC, performance must be presented on an unlevered basis;
- Obtain **annual audited financial statements** for each fund advised by the adviser, and deliver the audited financial statements to each of the fund's investors;
- Obtain an independent, professional **fairness opinion** for all "adviser-led secondary transactions" and deliver copies of the opinion to investors participating in the transaction;
- Prepare and retain a written report of the adviser's **annual compliance program review**;
- **Disclose** to all prospective investors in a fund, prior to investment, the details of any **preferential rights granted** to any of the fund's investors;* and
- Disclose annually to all fund investors the details of any preferential rights granted to any of the fund's investors.*

**The last two bullets apply to all private fund advisers, including those that are not required to register.*

New Prohibitions

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The new rules, if adopted as proposed, will **prohibit** all registered and exempt-reporting advisers to private funds from:

- Providing preferential treatment to one or more investors with respect to (i) redemption or other liquidity rights, or (ii) access to information regarding portfolio investments and exposures;
- Accelerating the payment of portfolio company monitoring fees;
- Allocating to a fund costs related to government examinations or investigations of the adviser;
- Allocating to a fund adviser-level regulatory or compliance related costs;
- Allocating costs related to portfolio investments held by multiple funds and co-investment vehicles on a non *pro rata* basis;
- Returning clawbacks of carried interest net of taxes;
- Benefiting from any indemnification or limitations of liability for breach of fiduciary duty, willful malfeasance, bad faith, recklessness or simple negligence; and
- Borrowing from a fund.

Q2: I am an adviser that already prepares audited financial statements for our fund(s). How does the new audit requirement differ from the Custody Rule's audit requirement?

A2: The proposed audit requirement differs from the Custody Rule's audit requirement in a number of respects. For example, the proposed rules:

- Require the adviser to take "all reasonable steps" to cause funds advised but not controlled by the adviser (e.g., sub-advised funds) to prepare and deliver audited financial statements;
- Require advisers to "promptly" deliver statements after completion of the audit (instead of within 120 days of the fund's fiscal year end);
- Require the auditor to notify the SEC if (i) the auditor resigns or is terminated, or (ii) the auditor is unable to deliver a clean opinion.

  If you do not already prepare audited financial statements for the fund(s) you manage: The new rules do not have a surprise audit alternative.

Q3: What is an "adviser-led secondary transaction" that requires a professional, independent fairness opinion?

A3: An adviser-led secondary transaction is defined as a transaction in fund interests **initiated by the investment adviser** that offers fund investors a choice to either:

- sell all or a portion of their interests in the fund; or
- 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.

  Secondary transactions in which an adviser provides assistance on an LP's request, but is not involved in setting the price for the transaction, would not be considered "adviser-led."

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Q4: What about my business would change under the proposed rules?

A4: It depends. Much of the proposal aligns with current industry best practices and is already part of business-as-usual for private fund advisers with sophisticated institutional clients. For example, many advisers already:

- Provide quarterly statements (albeit the form and content of these statements may have to change to comply with the new proposed requirements);
- Prepare and provide audited financial statements for their funds; and
- Obtain fairness opinions in connection with fund restructurings, continuation funds and other secondary transactions;
- Document the results of their annual compliance program reviews in writing.

However, other aspects of the proposal represent costly, time consuming and logistically challenging undertakings. For example:

- The proposed new disclosure requirements with respect to preferential treatment will be burdensome and logistically challenging to implement as compared to current practices regarding side letters and fund closing processes; and
- The prohibitions on returning clawbacks net of taxes and indemnification for simple negligence are inconsistent with market practice.

Q5: When will we know whether the rules will be adopted?

A5: We will not know for months, perhaps years. Market participants will have 30 days after the proposal is published in the Federal Register or until April 11, 2022, whichever is later, to submit comments on the proposal to the SEC. There is no proscribed timeline thereafter by which final rules must be completed and released.

Q6: If the proposed rules are not yet adopted, why should I care now?

A6: You should care for at least two reasons:

- In a recent Risk Alert, the SEC's Examination Division highlighted a number of the issues identified in the rules proposal. The SEC could regulate through examination and enforcement in advance of the Commission completing a final rulemaking.
- The proposal has been a long time coming and many significant components of the proposal are likely to be adopted. Chair Gensler, Commissioners Lee and Crenshaw all issued similar, full-throated endorsements of the proposal. However, Commissioner Pierce issued a dissenting statement and voted against the proposal. The proposal has been met with nearly instantaneous and strenuous objections from the private fund industry. Accordingly, we expect a robust comment process that may lead to modifications before the final rules are adopted.

Q7: How did we get here?

A7: The SEC's focus on the private fund industry has steadily grown since 2010 and has

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dramatically intensified over the last year.

- In December 2020, the SEC replaced the advertising and solicitation rules for advisers, with the new Marketing Rule. The new rule significantly impacts communications between private fund advisers and investors in private funds. Compliance is required by November 2022.
- In the SEC's Spring 2021 regulatory agenda, the new SEC Chair included increased regulation of the private fund industry – alongside cryptocurrency, SPACs, and ESG disclosures – as one of his top regulatory priorities.
- In November 2021, Chair Gensler told the ILPA Summit that the time has come to "take stock" and "bring sunshine and competition to the private fund space" because private funds – which manage $17 trillion – play an important role in the country's capital markets.
- On January 26, 2022, the SEC proposed updates to reporting requirements on Form PF.
- On January 27, 2022, the Examination Division released the Risk Alert referenced above, entitled "Observations from Examinations of Private Fund Advisers."
- On February 9, 2022, the SEC issued its 341-page rules proposal for increased regulation of advisers to private funds.
- On February 9, 2022, the SEC also proposed cybersecurity-related rules for investment advisers that would, among other things, require firms to (1) disclose cybersecurity risks and incidents on the Form ADV 2A and (2) report significant cybersecurity incidents on a new Form ADV-C. The comment period for the proposal is the same as described in A5 above.

Q8: Is there anything else I need to know?

A8: Yes. We will soon publish a more detailed analysis of the Feb. 9 proposals. In the meantime, we note that all investment advisers are required to comply with the new **Marketing Rule** by no later than **November 5, 2022**. We strongly recommend that you begin planning for this deadline now. As a practical matter, we suggest drafting any offering documents or marketing materials with new Rule's disclosure standards in mind, especially if you anticipate using the materials after your firm converts over to compliance with the new Rule.

The following Gibson Dunn attorneys assisted in preparing this client update: Gregory Merz, Lauren Cook Jackson, and Crystal Becker.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Investment Funds practice group, or any of the following:

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