Investment Management ADVISORY ■

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SEC Proposes Rules for Private Fund Advisers

Early last month, on February 9, 2022, the U.S. Securities and Exchange Commission (SEC) proposed a number of sweeping new and amended rules the under the U.S. Investment Advisers Act of 1940, as amended, focusing on private fund advisers. The proposed rules came in two separate releases from the SEC:

- Private Fund Advisers; Documentation on Registered Investment Adviser Compliance Reviews
- Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies

The proposed rules, taken together and with other recent rulemaking actions by the SEC in recent months,[1] represent an unprecedented rulemaking season by the SEC and by far the most significant rulemaking proposals directed toward private fund advisers during the tenure of the SEC's current chairman, Gary Gensler.

The Proposed Rules

The private fund adviser proposal

According to the SEC's staff, the purpose of the proposed rules under the private fund adviser proposal is to protect private fund investors by increasing their visibility into certain practices, establishing requirements to address practices that have the potential to lead to investor harm, and prohibiting adviser activity that is contrary to the public interest and the protection of investors. The private fund adviser proposal was designed to meet this objective by way of the following proposed rules:

[1] See:

- The SEC's January 27, 2022, Risk Alert issued by the Division of Examinations concerning adviser deficiencies: Observations from Examinations of Private Fund Advisers.
- The SEC's proposed amendments to Form PF issued on January 26, 2022, proposing real-time SEC reporting on adverse events: Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers.
- The SEC's reporting proposals issued on February 10, 2022, concerning amended ownership reporting rules under the U.S. Securities Exchange Act of 1934, as amended: Modernization of Beneficial Ownership Reporting.
- The proposed new rules under the Exchange Act issued by the SEC on December 15, 2021, concerning swap position reporting and prohibitions on fraud, manipulation, and deception in connection with securities-base swaps: Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition Against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions.

- Quarterly Statement Rule. Provide investors with quarterly statements detailing information about private fund performance, fees, and expenses (applies only to registered private fund advisers).
- Private Fund Audit Rule. Obtain an annual audit for each private fund and cause the private fund's auditor to notify the SEC upon certain events (applies only to registered private fund advisers).
- Adviser-Led Secondaries Rule. In connection with an adviser-led secondary transaction, distribute to investors a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider (applies only to registered private fund advisers).
- Prohibited Activities Rule. Prohibits *all* private fund advisers from engaging in certain activities and practices that are contrary to the public interest and the protection of investors.
- Preferential Treatment Rule. Prohibits *all* private fund advisers from providing certain types of preferential treatment that have a material negative effect on other investors, while also prohibiting all other types of preferential treatment unless disclosed to current and prospective investors.
- Compliance Rules and Books & Records Rules Amendments. Require, respectively, (1) *all* advisers to retain records related to the proposed rules; and (2) *all registered* advisers to document the annual review of the adviser's compliance policies and procedures in writing.

The cybersecurity proposal

According to the SEC's staff, the purpose of the proposed rules under the cybersecurity proposal is to protect private fund investors by increasing their visibility into certain practices, establish requirements to enhance cybersecurity preparedness, and improve the resilience of investment advisers and investment companies against cybersecurity threats and attacks. The cybersecurity proposal proposes to meet this objective by way of the following proposed rules:

- Cybersecurity Risk Management. Require advisers and funds to adopt and implement written policies and procedures that are reasonably designed to address cybersecurity risks.
- Reporting Significant Cybersecurity Incidents. Require advisers to report significant cybersecurity incidents to the SEC on proposed Form ADV-C.
- Disclosing Cybersecurity Risks and Incidents. Enhance adviser and fund disclosures related to cybersecurity risks and incidents.
- Recordkeeping. Require advisers and funds to maintain, make, and retain certain cybersecurity-related books and records.

Additionally, *both sets of proposed rules* also include amendments to the books and records rule under the Advisers Act that would require advisers to retain records to facilitate the SEC's ability to assess an adviser's compliance with such rules.

Comment period & applicability

The proposed rules remain subject to public comment for 60 days following the February 9, 2022, publication of the private fund adviser proposal and the cybersecurity proposal on the SEC's website (i.e., until April 11, 2022) or, if longer, 30 days after the proposed rules are published in the *Federal Register* (which has yet to occur). As a general matter, this presents a relatively short comment period given the broad scope of the proposed rules.

If the proposed rules are adopted, advisers will have a one-year transition period to bring their advisory contracts and practices into compliance with the new rules. Significantly, in terms of the practical impact on advisers, the proposed rules do not include any grandfathering provisions. Therefore, unless such provisions are included in the adopting release of the final rules, advisers should be prepared to perform sweeping reviews of their advisory contracts, programs, and practices and expect to make comprehensive updates to (and in some cases, unwind) existing practices that have long been considered as market standard in the private funds industry.

Finally, certain of the substantive requirements and prohibitions imposed by the proposed rules would apply not only to SEC-registered investment advisers (RIAs) but also to private fund advisers (U.S. and non-U.S.) that rely on the SEC's "exempt reporting adviser" (ERA) exemption, and often apply to all advisers, not simply private fund advisers.

Discussion of the Private Fund Adviser Proposal

Quarterly statement rule

The proposed rules would require *registered private fund advisers* (i.e., private fund RIAs) to distribute a quarterly statement to private fund investors with a detailed accounting of all fees and expenses paid by the private fund during the reporting period, generally within 45 days of each quarter end.

Each quarterly statement must provide:

- Compensation. A detailed accounting of compensation and other amounts paid (or allocated) to the adviser or its related persons. The report must include disclosures concerning the impact of any offsets, rebates, or waivers. Additionally, the adviser must provide a detailed accounting of compensation or other amounts paid by the private fund's portfolio investments to the adviser or any of its related persons.
- Private Fund Expenses. A detailed accounting of other fees and expenses paid by each private fund during the relevant reporting period.

  Note: Compensation, fees, or expenses reporting must be shown as a separate line item detailing the corresponding amount paid.
- Private Fund Ownership. Each private fund client's ownership of each covered portfolio investment.
- Performance Reporting.
  - Private fund reporting for "illiquid funds"[2] – 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.
  - Private fund reporting for "liquid funds"[3] – gross and net internal rate of return (IRR) and gross and net multiple of invested capital (MOIC) for the illiquid fund to capture performance from the fund's inception through the end of the current calendar quarter.

For added clarity, the SEC commented that for purposes of the marketing rule under the Advisers Act, the information displayed in the quarterly statements *would not* be considered an "advertisement" under the marketing rule; however,

[2] The SEC generally considers a "liquid fund" to be any private fund that is not an illiquid fund.

[3] An "illiquid fund" is generally defined by the SEC as any private fund with a limited life span, limited capital-raising period, and a predominant strategy of returning disposition proceeds to investors that does not routinely acquire market-traded securities and derivative instruments. This includes closed-end funds that do not offer periodic redemption rights.

it also noted that an adviser offering new or additional investment advisory services for the securities in the quarterly statement would need to consider whether such information would be subject to the marketing rule.

Practical Takeaways: All RIAs (i.e., not only private fund advisers) should consider taking steps to begin reviewing their various compensation, fee, and expense items in an effort to determine the impact of this proposed rule on the adviser. Begin considering how to administratively implement these new reporting requirements.

Private fund audit rule

The proposed rules would require *registered private fund advisers* (i.e., private fund RIAs) to cause the private funds they advise to undergo a financial statement audit at least annually (and upon liquidation) and to distribute such audited financials promptly after the completion of the audit. Additionally, the governing agreement with the accounting firm must require that the auditor notify the SEC's Division of Examinations within four business days of the termination of the auditor's engagement or promptly upon the issuance of a modified opinion.

The SEC views this as an "important check on the adviser's valuation of private fund assets" (which often serve as the basis for the calculation of the adviser's fees) and protection for private fund investors against misappropriation of fund assets.

Practical Takeaways: Private fund RIAs should consider the additional cost of being required to comply with this proposed rule should it go into effect and ensure that they have the appropriate resources to comply. Additionally, advisers should note that compliance with this proposed rule is separate from the adviser's obligation to comply with the custody rule (Rule 206(4)-2 under the Advisers Act), noting however that there are substantial overlaps. Importantly, unlike under the custody rule, the proposed rules do not provide for the option of a surprise examination in lieu of an audit and may end the practical use of that option for private fund RIAs.

Adviser-led secondaries rule

The proposed rules would require a *registered private fund adviser* (i.e., private fund RIA) to obtain a fairness opinion in connection with an adviser-led secondary transaction. The SEC stated that this requirement would provide a check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors.

Specifically, this proposed rule requires each private fund RIA seeking to complete an adviser-led secondary to first distribute to the selling fund's investors:

- A written opinion obtained from an independent provider that would opine on the fairness of the price being offered to the private fund for any assets being sold as part of the transaction.
- A written 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.

Practical Takeaways: This opinion requirement would be a threshold item for any selling fund's limited partner advisory committee (LPAC) or similar approval process, including in what would otherwise be a fair and competitive sale process. Therefore, there may be situations where the opinion yields an unfavorable price being offered for the assets being sold. Additionally, commentators have noted that the adviser-led secondaries rule does not address a number of anticipated issues, including the scope of the opinion and the potential for sponsor liability, and thus expect any adopting release to, ideally, include such additional detail.

Prohibited activities rule

The proposed rules would prohibit *all private fund advisers* (i.e., RIA and non-RIA private fund advisers) from engaging in certain activities and practices that are contrary to the public interest and the protection of investors. From the SEC's perspective, prohibiting these practices would address conflicts of interest that could reasonably lead to fraud and investor harm because, according to the SEC, they incentivize an adviser to place its interests ahead of the private fund's interests.

These prohibited practices include:

- Charging any of the following fees and expenses to a private fund:
  - Monitoring, servicing, consulting, or other fees ("supplemental fees") for any services that the investment adviser does not, or does not reasonably expect to, provide to the fund's underlying portfolio investment (e.g., accelerated fees).
  - Fees or expenses associated with an examination or investigation of the adviser or its related persons by any government or regulatory authority.
  - Regulatory or compliance fees or expenses ("compliance costs") of the adviser or its related persons.
- 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, recklessness, or even ordinary negligence in providing services to the private fund.
- Reducing the amount of an adviser clawback by the amount of any actual, potential, or hypothetical taxes applicable to the adviser or its related persons or owners.
- Charging or allocating fees or expenses related to a portfolio investment on a non-pro-rata basis—i.e., when multiple private fund clients and other clients of the adviser have invested (or proposed to invest) in the same portfolio investment.
- Borrowing or receiving an extension of credit (including borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit) from a private fund client.

<u>Practical Takeaways</u>: Because the proposed rules would provide an outright ban on the listed activities, such activities would be unlawful under the Advisers Act regardless of any existing contractual arrangement, disclosures to investors, authorization in a private fund's governing documents, or approvals from private fund investors or LPACs. Advisers should consider their existing fee, expense, and reimbursement arrangements and take stock of how they would hold up against the proposed rules if enacted.

Preferential treatment rule

The proposed rules would prohibit *all private fund advisers* (i.e., RIA and non-RIA private fund advisers) from providing certain enhanced liquidity and information rights to private fund investors (including via side letter) under circumstances where the adviser reasonably expects such rights to have a material, negative effect on the other investors in the relevant private fund (or similar vehicle). Under those circumstances, this preferential treatment rule imposes an outright ban on providing any of the following:

- <u>Liquidity Preference.</u> Providing preferential terms to certain investors regarding redemptions from the fund or information about portfolio holdings or exposures.

- Transparency Preference. Providing other preferential treatment unless disclosed to current and prospective investors.

Additionally, the proposed rules generally prohibit advisers from providing any other preferential treatment to any private fund investor (or similar vehicle investor), unless the adviser provides detailed written disclosures to prospective and current investors in the fund. For purposes of clarity, the SEC has indicated that it would be insufficient for an adviser to simply state that certain fund investors are entitled to a lower fee rate; rather, the disclosure must provide the specific fee terms or at least the specific range of fees offered.

The SEC has stated that these prohibitions are designed to protect investors by prohibiting specific types of preferential treatment that have a material, negative effect on other investors. The SEC believes that increased transparency would better inform investors about the breadth of preferential treatment, the potential for those terms to affect their investment in the private fund, and the potential costs (including compliance costs) associated with these preferential terms.

Practical Takeaways: The preferential treatment rule would directly impact private fund advisers and the ways they conduct their investor relations activities. Advisers and fund investors alike may lose out on negotiating power if this proposed rule is enacted. As a matter of initial steps, advisers should review the prohibited activities under both the preferential treatment rule and the prohibited activities rule and assess whether their current practices would be in compliance with the proposed rules. Ultimately, the proposed rules could affect the method by which the adviser arranges its compensation structure.

Compliance rules and books & records rules amendments

The proposed rules include amendments to (1) the compliance rule under the Advisers Act that requires *all registered advisers* (i.e., all RIAs, including those that do not advise private funds) to document their annual review in writing; and (2) the books and records rule under the Advisers Act that requires advisers to retain records related to the proposed rules. The SEC believes these amendments would facilitate the SEC's ability to assess an adviser's compliance with the proposed rules.

Practical Takeaways: RIAs should consider whether these implications of the proposed rules will require updates to the adviser's existing recordkeeping systems, processes, and procedures. ERAs will need to likewise consider the effect of the new requirements of these proposed rules on their business.

Discussion of the Cybersecurity Proposal

The SEC acknowledges in the cybersecurity proposal that advisers and funds play an important role in our financial markets and, like many industries, increasingly depend on technology for critical business operations. The SEC believes that, as a result of advisers and their funds being exposed to, and relying upon, a broad array of interconnected systems and networks, they face numerous cybersecurity risks and may experience cybersecurity incidents that can cause or be exacerbated by critical system or process failures. Therefore, the proposed rules in the cybersecurity proposal are designed to (1) address concerns about advisers' and funds' cybersecurity preparedness and reduce cybersecurity-related risks to clients and investors; (2) improve adviser and fund disclosures about their cybersecurity risks and incidents; and (3) enhance the SEC's ability to assess systemic risks and oversee advisers and funds.

The proposed rules under the cybersecurity proposal would specifically address the following matters pertaining to an adviser's ongoing business and its and its private funds' exposure to cybersecurity issues:

- Cybersecurity Risk Management. The proposed rules would require advisers and funds to adopt and implement policies and procedures that are reasonably designed to address cybersecurity risks. Additionally, the proposed rules would require RIAs to conduct the following activities at least annually:
  - Review and assess the design and effectiveness of their cybersecurity policies and procedures.
  - Prepare a written report that would: (1) describe the annual review, assessment, and any control tests performed; and (2) explain the results.
  - Document any cybersecurity incident that occurred since the date of the last report.
  - Discuss any material changes to the policies and procedures since the date of the last report.
- Reporting Significant Cybersecurity Incidents. The proposed rules include a reporting requirement that would require advisers to report significant cybersecurity incidents[4] to the SEC, including on behalf of a fund or private fund client, by submitting a new Form ADV-C.
- Disclosing Cybersecurity Risks and Incidents. The proposed rules would require advisers to disclose cybersecurity risks and incidents to the adviser's clients and prospective clients, both on Form ADV Part 2A (as amended pursuant to the proposed rules) and in investor and prospective investor disclosures (e.g., most likely in the adviser's private placement memoranda).
- Recordkeeping. The proposed rules would amend the existing books and records rule under the Advisers Act (Rule 204-2) to require advisers to maintain certain records related to the proposed cybersecurity risk management rules and the occurrence of cybersecurity incidents. Similarly, the proposed rules would also require that a fund maintain copies of its cybersecurity policies and procedures and other related records specified under the proposed rules.

Practical Takeaways: Advisers should be on alert that the formalities surrounding cybersecurity reporting and recordkeeping would become substantially more thorough. Advisers should also be prepared to formalize their incident response plan in order to timely comply with the new Form ADV-C requirement under the proposed rules. As a matter of initial steps, advisers should consider undertaking a review of their current incident response plans and other cybersecurity policies and procedures and consider the impact of revising them to bring them in compliance with the proposed rules.

Conclusion

The proposed rules are currently in a comment period and will eventually go through a year-long transition period before coming into effect. Alston & Bird is in continued discussions with industry groups and experts to stay on top of the changing regulatory landscape for investment advisers and alternative asset managers, particularly as we evaluate the proposed rules and monitor related SEC guidance and similar developments.

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4 The SEC has proposed to define a "significant adviser cybersecurity incident" as: "a cybersecurity incident, or a group of related incidents, that significantly disrupts or degrades the adviser's ability, or the ability of a private fund client of the adviser, to maintain critical operations, or leads to the unauthorized access or use of adviser information, where the unauthorized access or use of such information results in: (1) substantial harm to the adviser, or (2) substantial harm to a client, or an investor in a private fund, whose information was accessed.

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