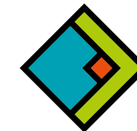
A review of the new SEC proposals and the impact on private funds and advisors



The Bright Alternative

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Background

2022 has seen a number of proposed and enacted reforms which will significantly impact US private fund managers.

The Strengthening American Cybersecurity Act of 2022, which was passed by the US Senate in March 2022, applies to financial service organizations and adds another level of compliance for managers, as they must report cyber-attacks within 72 hours (reduced to 24 hours if a ransomware payment has been made). Disclosure of cyber-events exposes an organization's weaknesses, so there is even more incentive for US managers to continue to invest heavily in their IT security environment.

In respect of the new marketing rules, which will come into force in November 2022, investors will likely see different PPM material for successor funds, especially around case studies and testimonials. Managers will need to ensure that they are transparent about any sponsored testimonials and going forward, case studies can't cherry pick performance.

On February 9, 2022, the Securities and Exchange Commission (the "SEC") published a set of proposed rules and amendments to the Investment Advisors Act of 1940 as amended (the "Act"). This guide focuses on the proposed amendments to the Act and the impact on private fund managers.

The Rules seek to increase investor protections through transparency and conflicts management in the private funds space and fly in the face of the principles-based approach to regulation (relying on self-disclosure) that has been a hallmark of the SEC's approach for many years.

The Rules represent the biggest SEC rule making exercise in the private funds space since the introduction of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which brought most large private fund advisers under SEC control. While the Dodd-Frank reforms specifically targeted private fund advisers, the Rules will operate on private funds through their associated advisers. In common with recent rule-making in the EU, the Rules seek to enhance investor protection among the institutional investor community, applying principles more commonly reserved for retail investors in an arguably wrong-headed way.

While the SEC's approach in proposing the Rules is in some senses unexpected, their impact may be more or less seismic for any given adviser, based on the size, maturity and complexity of that adviser's business. A lack of grandfathering provisions, however, will add complexity to implementation, applying the Rules to existing as well as new private fund arrangements. Parallels in approach with recent EU rulemaking are hard to ignore (i.e. the adoption of an increasing prescriptive approach for institutional investor focussed products) and it will be interesting to see whether the US market tolerates this approach and how successful it will be.

In this guide, we provide an overview of the new rules together with some commentary on the main implications for advisers of closed ended private funds.

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Who is in scope?

All of the Rules will apply in connection with private funds advised by SEC registered investment advisers (“**RIA**”). In addition, the Rules concerning prohibited activities will apply to both State registered investment advisers (i.e., US based small and mid-sized investment advisers that are prohibited from registering with the SEC) and to both US and non-US Exempt Reporting Advisers (“**ERA**”) (in a closed ended funds context, those typically relying on one of the Foreign Private Advisers, Private Fund Advisers or Venture Capital Advisers exemptions).

US based ERAs may expect and accept this, but a large number of ERAs are neither US based, nor do they have US funds and are caught only as a result of having US investors in their funds. The extension of some fairly prescriptive and prohibitive rules to these ERAs may be both unexpected and unwelcome and it will be interesting to see whether this impacts the willingness of those advisers to make fund investment opportunities available to US investors prospectively; a trend that has been observed in Europe where EU rules are applied to US advisers/funds in circumstances where EU investors are marketed to.

What are the rules?

The Rules can be broken down into five areas:

Rule	Application
Quarterly statements	RIA
Mandatory audit	RIA
Compliance review	RIA
Adviser led secondaries	RIA
Prohibited activities	All advisers to private funds (including State registered and ERA)

Quarterly statements

RIA will be required to provide investors with quarterly statements within 45 days of the quarter end, containing certain prescribed information covering the fees and expenses of the private fund and the portfolio together with certain performance information as follows:

1. **The Fund Table:** the following information must be presented both before and after the application of any offsets, rebates or waivers:

   a. a detailed accounting of all compensation, fees and other amounts allocated or paid to the RIA or any of its related persons by the private fund during the reporting period;
   b. a detailed accounting of all other fees and expenses paid by the private fund during the reporting period; and
   c. the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the RIA or its related persons.

2. **The Portfolio Investment Table:** the following information must be disclosed for each covered portfolio investment:

   a. a detailed accounting of all portfolio investment compensation allocated or paid to the RIA or any of its related persons by the covered portfolio investment during the reporting period; and
   b. the private fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period along with a brief description of the private fund's investment.

3. **Performance:** for illiquid funds the following performance measures, shown since inception to the end of the quarter covered by the report, computed without the impact of any private fund-level subscription facilities:

   a. gross and net IRR and MOIC;
   b. gross IRR and gross MOIC for the realised and unrealised portions of the portfolio with the realised and unrealised performance shown separately; and
   c. a statement of contributions and distributions.

Where consolidation for substantially similar pools of assets would provide more meaningful information to a private fund's investors and would not be misleading, the RIA must consolidate.

For most RIAs, these prescriptive requirements are unlikely to result in too many changes having to be made to their quarterly reports and most RIAs will already have the necessary information available to them to report on the specified metrics.

Reporting within 45 days of a quarter end, however, is at the lower end of the time limit generally specified for quarterly reports so this will require consideration across existing fund structures. Fund of funds may also encounter some difficulty in collating this information within a 45 day time frame if the underlying funds that they invest in are also working to the same deadline and it will be interesting to see whether the SEC are amenable to providing any leeway in connection with such funds (given the precedent set for fund of funds in complying with the financial statements filing requirements under the Custody Rule).

Mandatory audit

RIAs will have to cause any private funds that they advise to undergo a financial statement audit at least annually and on liquidation:

1. the audit must be performed by an independent public accountant that is registered with and subject to inspection by the Public Company Accounting Oversight Board;

2. audited financial statements must be prepared in accordance with US GAAP or for non-US private funds (or funds with non-US advisers/GP), another accounting standard that is substantially similar to US GAAP provided that material differences with US GAAP are reconciled;

3. audited financial statements must be distributed promptly after the audit is complete; and

4. the adviser must enter into a written agreement with the auditor under which the auditor can notify the SEC of any issues raised as part of the audit together with the end of the engagement.

The audit requirement largely duplicates existing audit practices of many RIAs under the Custody Rule, meaning that the impact of this provision is likely to be limited for many. The audit rule does not, however, provide any option for RIAs to rely on a surprise examination, which is available under the Custody Rule, so for those RIAs currently relying on this (commonly advisors to smaller private funds or to funds in wind down), changes will be required which will likely negatively impact the returns profile.

In introducing the audit rule, the SEC have also not provided any guidance on what ‘promptly’ means in the context of the requirement to deliver the completed audit report save to confirm that the 120 day time period specified in the Custody Rule will be too long.

Compliance review

The Rules will require all RIAs to document in writing their annual compliance review. The existing rule requires an annual review, but does not require that this is documented and, without this, the SEC have suggested that they are unable to properly evaluate compliance with the rule. In implementing this rule, the SEC has noted the use of client/attorney privilege as a means to shield compliance findings from SEC disclosure and noted that they would not expect the documentation produced as part of the compliance review to be subject to this. It will be interesting to see what approach RIAs take to the application of this going forwards and whether privilege will continue to be applied to pre-annual compliance process activities.

Adviser-led secondaries

RIAs to private funds that are looking to complete an adviser-led secondary transaction will be required to ensure that a fairness opinion is obtained from an independent opinion provider and is distributed to investors in the private fund together with a written summary of any material business relationships the RIA or its related persons has, or has had, with the independent opinion provider in the two years leading up to the date on which the secondary transaction is closed.

For these rules to apply, the secondary transaction must be adviser led, i.e. 'initiated by the investment adviser or any of its related persons'. They will not apply in cases where one or more LPs expresses an unsolicited interest in selling or where a buyer makes the first move. While the rule is aimed at protecting investors and ensuring a fair valuation, it remains to be seen whether this will really deliver any benefit for a process that generally involves one or more institutional buyers and a seller, the price for which had therefore historically been set by market forces (i.e., an auction process). It seems more likely that this will just layer in additional cost that will likely be offset against the purchase price.

Separately, it is not clear exactly what a 'material business relationship' comprises and this may become a contentious point unless further guidance is issued.

Prohibited activities

One of the main points covered by the new Rules is the series of prohibitions to be placed on all investment advisers (including State registered investment advisers and ERAs) aimed at preventing certain conflicts of interests from arising. This prescriptive rule making is a significant departure from the SEC's historic approach and cuts across the existing approach to the management of conflicts for affected advisers.

The prohibitions are as follows:

1 Fees for unperformed services

Advisers will be prohibited from charging monitoring, servicing, consulting or other fees to a portfolio entity for services that the adviser does or does not reasonably expect to provide.

This prohibition is really aimed at the charging of accelerated monitoring fees which is no longer common practice. The 'reasonably expects' standard may generate a degree of uncertainty over the application of this rule, but there is no suggestion that this prohibition will cover services actually performed (even when charged for in advance) and it is not considered a material prohibition.

2 Fees for compliance

Advisers will be prohibited from charging the private fund for fees/expenses associated with an examination or investigation of the advisor by any governmental or regulatory body and will also be prohibited from charging the private fund for any regulatory or compliance fees or expenses of the adviser or its related persons.

Advisors will need to exercise some care in determining whether to allocate fees to a private fund which cover adviser or portfolio compliance costs as they relate to the private fund, but based on current market norms around compliance cost allocations, this is not considered a material prohibition.

3 GP clawback

Advisers will be prohibited from reducing the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons or their respective owners.

If enacted in its current form, this prohibition could prove difficult in connection with existing funds where a recalculation of clawback amounts may be required. It may also have an impact prospectively on an adviser's decision to operate deal by deal vs whole fund carry and may separately have a wider impact on the economics of the fund more generally. Having said that, certain advisers already include this as standard in their fund documents so its impact may be limited depending on how advisers have approached this issue to date. Advisers will need to carefully check existing LPAs to ensure that drafting is appropriate.

4 Limitation of liability

Advisers will be prohibited from seeking reimbursement, indemnification, exculpation, or limitation of their liability by a private fund or its investors for a breach of fiduciary duty, wilful misfeasance, bad faith, negligence, or recklessness in providing services to a private fund.

This prohibition may negatively impact the freedom with which an adviser makes investment decisions, cutting across the accepted risk profile of a closed ended fund investment and likely resulting in a reduced return profile. While the prohibition may be suitable when retail investors are involved, the logic of its implementation has to be questioned in the context of an institutional investor backed fund. Existing fund documents may require amendment to deal with this change in liability position which will generate more cost for investors.

5 Pro-rata allocation of fees

Advisers will be prohibited from charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non pro-rata basis when multiple private funds and other clients advised by the adviser or its related

Prohibited activities

persons have invested (or propose to invest) in the same portfolio investment.

Under this prohibition, broken deal costs will need to be allocated to investors pro-rata, including among any co-investment vehicles (that have executed a binding agreement to participate in the transaction) which are often exempt from such costs under existing market practice. This prohibition may, therefore, have a negative impact on an adviser's ability to raise co-investment capital and will also likely have administrative implications for more complex deals.

6 Borrowing

Advisers will be prohibited from borrowing money, securities, or other private fund assets, or from receiving a loan or an extension of credit, from a private fund client.

This prohibition seems inoffensive but going forwards advisers will need to consider whether things like cashless GP contributions and payment of fees/organizational expenses that are subject to management fee offset, for example, may be classified as borrowings.

7 Preferential terms

Advisers will be prohibited from:

a. Preferential terms: granting preferential liquidity terms or information disclosures to an investor if the adviser reasonably expects that providing the preferential terms or information would have a material negative effect on other investors in the relevant fund.

b. Terms disclosure: directly or indirectly providing any other preferential terms to any investor in the private fund, unless the adviser provides written notices as follows:

i. advance written notice for prospective investors in a private fund; and

ii. annual written notice to current investors in the fund – covering any preferential treatment afforded to investors in the preceding 12 months.

The preferential terms prohibition could have certain practical implications for advisers to private funds. Preferential liquidity terms are less of a concern for closed ended fund advisers, but the preferential terms prohibition on information disclosures could be hard to apply in practice, leaving advisers to make a judgement call over which of the preferential (reporting) terms requested as part of a standard side letter negotiation will have a material negative effect on other investors if granted and additionally, absent grandfathering provisions, whether existing negotiated terms breach this rule.

The terms disclosure rules are also likely to cause practical issues with summary terms or redacted side letters having to be disclosed to all other investors before they invest. This may have a negative impact, in particular on anchor or other significant investors who would typically expect more favourable terms and may also complicate and negatively impact closing mechanics.

The SEC has not provided guidance on what constitutes 'preferential treatment' or 'specific information' which may complicate the disclosure process unless further guidance is issued.

Entry into force and conclusions

The consultation period in connection with the introduction of the Rules was originally scheduled to run until the later of April 11, 2022 or 30 days from the date that the proposal is published in the Federal Register, but on May 9, 2022 the **SEC announced** that it would be re-opened for a period of 30 days following publication of a reopening release in the Federal Register. **The re-opening release** was published on May 12, 2022 with a new deadline for the receipt of comments by June 13, 2022.

The Rules as currently proposed anticipate a one year transitional period which will run from the date falling 60 days following the publication of the final rules in the Federal Register. Given the re-opened consultation period, we can expect the Rules to be in force September/October 2022 with compliance required by September/October 2023.

The Rules as currently drafted are likely to have a significant impact on the private funds space and it's hard not to see a parallel between the approach of the SEC in proposing these new Rules and that of European regulators over the past decade, moving towards a more prescriptive model of regulation that borrows ideas from, and is ultimately more suited to, the retail space. In Europe the results have been mixed, with cross border distribution becoming more difficult and fund costs increasing. Only time will tell whether the results in the US will be the same.

To the extent that you wish to discuss the application of any of the rules to your existing or anticipated fund structures, please get in touch. Aztec Group offers a full administrative solution to all closed ended private fund advisers including outsourced compliance support and financial reporting and we are well placed to assist you with any revised quarterly reporting requirements, compliance with ongoing prohibited activities and with your annual compliance process.

If you would like to discuss any of the topics in this guide, as well as how the Aztec Group can support you, please talk to either your usual contact or get in touch with:

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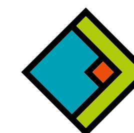

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