Alert

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COZEN O'CONNOR

SEC Proposes Extensive New Regulations for Private Fund Advisers

Proposed Rules

In an extensive release,[1] the U.S. Securities and Exchange Commission (**SEC**), proposed new and amended rules (collectively, the **Proposed Rules**) under the Investment Advisers Act of 1940 (the **Act**) that would impose specific disclosure requirements, increase reporting requirements, and prohibit certain activities and practices, primarily impacting private fund advisers. The Proposed Rules, if adopted in their current form, would significantly increase the regulatory scheme imposed on private fund advisers under the Act.

Most notably, the Proposed Rules would:

- require private fund advisers that are registered or required to be registered under the Act to provide to private fund investors a quarterly report showing the fees, expenses, and performance for each private fund and to maintain records relating to the quarterly statements;
- mandate registered private fund advisers to obtain an annual financial statement audit of each private fund it advises and a fairness opinion in connection with adviser-led secondary transactions;
- require all registered advisers, whether or not they advise private funds, to document in writing the annual review of their compliance policies and procedures; and
- prohibit all private fund advisers, whether or not registered, from engaging in certain activities and practices, including, but not limited to:
  - charging certain fees and expenses to the private fund,
  - reducing the advisers carried interest clawback obligation by the amount of taxes,
  - seeking indemnification or exculpation for the adviser's negligence and other bad acts,
  - borrowing from a private fund managed by the adviser, and
  - providing preferential treatment to certain investors regarding redemption or information about portfolio holdings and exposures, and providing preferential treatment to certain investors regarding other matters without disclosing the disparity to all other current and prospective investors.

Quarterly Statements

The SEC posits that lack of transparency regarding private fund costs, performance, and preferential terms has caused a problematic information imbalance between advisers and private fund investors, leaving many investors without effective negotiation tools. To provide for greater transparency between the parties, the Proposed Rules would require investment advisers registered or required to be registered with the SEC to prepare and provide to its private fund investors quarterly statements for each of its private funds and related funds. Those statements would be due within 45 days of the end of each calendar quarter. The first statement would be due after the second full calendar quarter of the fund's operational results. The Proposed Rules would require advisers to retain books and records related to its quarterly statements, including a copy of each statement, records relating to the addressees and records evidencing the calculation methods for data included in the quarterly statements.

To allow for comparison among advisers' reports, the Proposed Rules broadly outline the requirements of a standard format and level of detail but fell short of prescribing a specific template.

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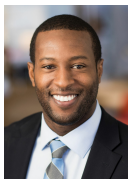

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Related Practice Areas

- Capital Markets & Securities
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The Proposed Rules would require quarterly statements to include a table that shows fee and expense information at the private fund level and at the portfolio investment level. At the *fund level*, the quarterly statement disclosure table would require at least the following information:

1. A detailed accounting of all compensation, fees, and other amounts (including performance-based compensation) allocated or paid to the adviser or any of its related persons by the private fund during the reporting period;
2. A detailed accounting of all fees and expenses paid by the private fund during the reporting period other than those listed above; and
3. 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.

At the *portfolio investment level*, the quarterly statement disclosure table would require at least the following information with respect to any covered portfolio investment:

1. A detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period; and
2. The private fund's ownership percentage of each covered portfolio investment as of the end of the reporting period.

As further guidance, the SEC included proposed definitions of a number of terms in the Proposed Rules to further define the disclosure requirements, and the SEC seeks comments regarding the breadth of those proposed definitions.

In addition to the fund level and portfolio investment level tables discussed above, the Proposed Rules would also require advisers to include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated. Descriptions of those calculations would also need to include references, as necessary, to the applicable governing or organizational documents of the fund.

Performance Disclosures

In furtherance of the SEC's stated goal of correcting the information imbalance between private fund advisers and investors, the Proposed Rules also require standardized fund performance information to be included in each quarterly statement provided to fund investors. Here again, the standardization is designed to allow investors to easily compare performance across different funds. The Proposed Rules set forth distinct metrics and requirements for liquid funds and illiquid funds, each designed to provide investors with standard information so that they might make better informed choices about their investments. The Proposed Rules would require fund advisers to include prominent disclosure of the criteria used and assumptions made in calculating the performance. By standardizing the performance metrics and required disclosure of the assumptions used to calculate those metrics, the SEC hopes to provide better information to investors so that they can more readily decide whether to continue to invest in a private fund, seek redemption, if redemption is possible, and more holistically make decisions about other components of the investor's portfolio.

In addition to the fee and expenses and performance disclosures, the Proposed Rules note that an adviser would otherwise generally remain free to include other performance metrics in the quarterly statement, as they see fit.

Mandatory Private Fund Adviser Audits and Adviser-Led Secondary Transactions

Mandatory Private Fund Adviser Audits

The Proposed Rules provide that registered private fund advisers would have to obtain an annual audit of the financial statements of the private funds they manage at least once per year and upon liquidation. The SEC believes that this requirement will provide added protection against misappropriation of fund assets and an important check on the adviser's valuation of fund assets. The requirements of the financial audit, as included in the Proposed Rules, are as follows:

1. the audit must be performed by an independent public accountant that meets the independence requirement of Regulation S-X and is registered with and subject to inspection by the Public Company Accounting Oversight Board;
2. the audit must meet the definition of "Audit" as provided under the Regulation S-X; and
3. the audit must be prepared in accordance with U.S. Generally Accepted Accounting Principles, subject to certain exceptions.

Once the audit is complete, the adviser must "promptly" distribute the fund's financial statements to its current investors. The SEC chose not to prescribe a specific time following the fund's fiscal year-end within which the audited financial statements must be delivered to provide more flexibility for situations outside the control of the adviser. However, the SEC notes that the custody rule's 120-day audit delivery requirement is generally appropriate for most private funds. If an adviser does not control a fund or that fund is not under the adviser's common control, that adviser would only be required to *take all reasonable steps* to see that the fund undertake the audit, as required by the Proposed Rules.

Notably, the Proposed Rules would also require an adviser, or the applicable fund, to enter into a written agreement with the independent public accountant performing the audit. That written agreement would provide that the accountant must notify the SEC (i) promptly upon issuing an audit report to the private fund that contains a modified opinion and (ii) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed. Additionally, the accountant making any such notification would be required to provide its contact information and indicate its reason for sending the notification to the SEC. Understanding that all steps in the audit process are not directly in the adviser's or fund's direct control, the SEC has also included language in the Proposed Rules that would only require the adviser to *take all reasonable steps* to cause its private fund client to undergo an audit. The Proposed Rules require advisers to retain books and records related to the audited financial statements, including a copy of each financial statement, records relating to the addressees and records documenting the steps taken by the adviser to cause a private fund not controlled by the adviser to undergo an financial audit.

Adviser-Led Secondaries

The Proposed Rules would require a registered private fund adviser to obtain a fairness opinion in connection with certain adviser-led secondary transactions; specifically, those in which the adviser offers fund investors the option to sell their interest in the fund or exchange their interests in the fund for interests in another vehicle advised by the adviser. The SEC states that this added requirement is to provide an important check against an adviser's conflicts of interest in structuring and leading transactions in which it may stand to profit at the expense of the fund or its investors. Accordingly, the Proposed Rules would require that the adviser obtain a written opinion stating that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair. The fairness opinion must be issued by a person who (i) provides fairness opinions in the ordinary course of its business and (ii) is not a related person of the adviser. Furthermore, the SEC's Proposed Rules would require that the adviser prepare and distribute to private fund investors a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider. The goal would be to mitigate even the appearance that a fairness opinion was unduly influenced by the relationship between an adviser and the opinion provider. Advisers would also be required to retain a copy of the fairness opinion and the material business relationship summary distributed to investors as well as a record of the addressees.

Prohibited Activities and Preferential Treatment

Prohibited Activities

In response to an observation that certain detrimental industry practices have persisted despite heightened disclosure obligations and SEC enforcement actions, the SEC now seeks to explicitly prohibit a private fund adviser from engaging in certain sales practices, conflicts of interest, and compensation schemes that it believes are contrary to the public interest and the protection of investors. The Proposed Rules would prohibit an investment adviser to a private fund, directly or

indirectly, from engaging in certain activities with respect to the private fund or its investors, including:

1. Charging certain:
    a. fees and expenses to a private fund or portfolio investment, including accelerated monitoring fees;
    b. fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities;
    c. regulatory or compliance expenses or fees of the adviser or its related persons;
    d. 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;
2. Reducing the amount of any adviser clawback by the amount of certain taxes;
3. 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; and
4. Borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client.

These prohibitions would apply to all advisers to private funds, regardless of whether they are registered with the SEC or one or more states, exempt reporting advisers, or prohibited from registration.

Preferential Treatment

The SEC identified that there are specific types of preferential treatment that have a material negative effect on other investors in a private fund and seeks to correct this negative effect under the Proposed Rules. The SEC recognizes the prevalence and importance of side letters and that not all preferential terms disadvantage other fund investors. Therefore, the Proposed Rules distinguish between the types of preferential treatment based on whether the SEC believes the preferential terms have a negative impact on other fund investors.

The Proposed Rules specifically prohibit a private fund adviser, including indirectly through its related persons, from granting an investor in the private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets. The Proposed Rules would also expressly prohibit an adviser and its related persons from providing information regarding the portfolio holdings or exposures of the private fund or of a substantially similar pool of assets to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.

For other types of preferential treatment, the SEC choose to rely on adequate disclosure in this context rather than an outright prohibition. Accordingly, the Proposed Rules would prohibit advisers from providing any other types of preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons are providing to other investors in the same fund. The SEC notes that the determination of whether terms are "preferential" would be fact dependent. For a prospective investor, the notice would need to be provided, in writing, prior to the investor's investment, and for an existing investor, the adviser would have to distribute the notice annually if any preferential treatment is provided to an investor since the last notice.

Advisers registered with the SEC would also be subject to certain record keeping requirements supporting their compliance with the preferential treatment rules.

Documentation of Annual Compliance Reviews

The Proposed Rules would amend the Act's compliance rule to require all registered advisers to document in writing the annual review of their compliance policies and procedures. The SEC believes that this new requirement would focus renewed attention on the importance of the annual

compliance review process and provide the SEC's exam staff with better visibility to determine whether an adviser has complied with the review requirement of the compliance rule.

Transition and Compliance

The SEC is proposing a one-year transition period to provide time for advisers to come into compliance with final rules if they are adopted. Accordingly, the SEC proposed that the compliance date of any adoption of the Proposed Rules would be one year following the rules' effective dates, which would be 60 days after the date of publication of the rules in the Federal Register.

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[1] Proposed rules. 17 CFR Part 275. [Release Nos. IA-5955; File No. S7-03-22]. SEC Proposes to Enhance Private Fund Investor Protection Press Release.