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Practice Update

SEC's New Proposed Rules Contain Changes for Investment Advisers of Private Funds

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By Paul J. Foley, John M. Faust, Kiki M. Scarff, and Brittany A. Puckett

On February 9, 2022, the Securities Exchange Commission (the SEC) proposed new rules, rule amendments, and a new Form ADV-C (the Proposed Rules) under the Investment Advisers Act of 1940 (the Advisers Act) that seek to further regulate investment advisers to private funds in a significant way. The Proposed Rules passed with votes of three to one, with Commissioner Hester Peirce dissenting in each vote. In her statement, Commissioner Peirce said, "Today's proposal represents a sea change" that "embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions." By contrast, Chair Gary Gensler said that the new regulations would "improve the efficiency, competition, and transparency of the activities of private funds' advisers."

In summary, the Proposed Rules would require quarterly statements be sent to investors describing fees and expenses and performance information, annual audited financial statements for private funds, fairness opinions for adviser-led secondary transactions, and written documentation of annual compliance reviews. In addition, the changes would prohibit certain fee and other arrangements and prohibit the preferential treatment of investors. The

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John M. Faust
Paul J. Foley
Brittany A. Puckett
Kiki M. Scarff

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changes also expand the scope of an investment adviser's books and records requirements. Lastly, the changes would mandate certain actions to prevent cybersecurity incidents.

Because the Proposed Rules do not contain any grandfathering provisions, if adopted in their current form, they would apply to existing governing agreements in addition to those entered into following the effective date of the Proposed Rules. Furthermore, while some of the Proposed Rules would only be mandated for investment advisers, other rule changes would be mandated for SEC-registered and unregistered investment advisers alike (including SEC-registered investment advisers, SEC and state exempt reporting advisers, state-registered investment advisers, and any other investment advisers not registered with the SEC). The following includes a high-level look at the Proposed Rules' key provisions:

Proposed Changes for SEC Registered Investment Advisers

- *Quarterly Statement Rule.* Proposed Rule 211(h)(1)-2 would require registered investment advisers to provide investors with (i) a detailed accounting of all fees and expenses paid by the private fund in a table format; (ii) information regarding compensation or other amounts paid by the private fund's portfolio investments to the investment adviser or any of its related persons in a single table; and (iii) information regarding the private fund's performance, with liquid funds providing net total returns and illiquid funds providing gross and net internal rates of return and gross and net multiples of investment capital. The quarterly statements required by the Proposed Rules would not be considered an "advertisement" under the Advisers Act's new marketing rule (Rule 206(4)-1). The quarterly statements would be required to be distributed to private fund investors within 45 days of each quarter end unless certain exceptions are met.

- *Investment Adviser-Led Secondaries Rule.* Proposed Rule 211(h)(2)-2 would require registered investment advisers to obtain a "fairness opinion" from an independent opinion provider confirming the fairness of the price for any investment adviser-led secondary transactions offered to investors within the private fund for any assets being sold as part of the transaction. In addition, investment advisers must prepare and distribute to private fund investors a summary of any material business relationships between the independent opinion provider and the investment adviser within the past two years.
- *Private Fund Audit Rule.* Proposed Rule 206(4)-10 would require registered investment advisers to obtain an audit of a private fund's financial statements at least annually and upon liquidation, with "prompt" distribution of the audited financial statements to the investors. We note that many registered investment advisers to private funds already provide audited financial statements to comply with the Advisers Act's custody rule (Rule 206(4)-2). However, in contrast to the custody rule, the Proposed Rules would require an independent public accountant to notify the SEC promptly upon the auditor's termination or issuance of a modified opinion. The Proposed Rules would require all private funds to obtain an audit regardless of whether they obtain a surprise examination under the custody rule. As a result, custody rule compliance would not necessarily guarantee compliance with the Proposed Rules and *vice versa*.
- *Compliance Rule Amendments.* Proposed amendments to Rule 206(4)-7 includes amendments to the compliance rule under the Advisers Act that would require registered investment advisers, including those that do not advise private funds, to document their annual review in writing.
- *Proposed Cybersecurity Rule*. Proposed Rule 206(4)-9 impose additional requirements on

registered investment advisers related to preventative risk management, reporting and disclosure requirements, and record keeping. Below are the key provisions of the proposed Cybersecurity Rule:

- Cybersecurity Risk Management. Investment advisers would be required to implement policies and procedures that are reasonably designed to address cybersecurity risks according to general elements listed in the cybersecurity rule. We note that many investment advisers have already implemented such policies and procedures.
- Reporting Significant Incidents. Investment advisers would be required to report significant cybersecurity incidents to the SEC, including on behalf of a fund or a client, by submitting a new Form ADV-C.
- Disclosure of Cybersecurity Risks and Incidents. Investment advisers would be required to amend Form ADV Part 2A to require disclosure of cybersecurity risks and incidents to current and prospective clients. We note that many investment advisers have already provided such disclosure in their Form ADV Part 2A.

- *Books and Records*. Proposed amendments to Rule 204-2 would amend the books and records rule under the Advisers Act to require investment advisers to maintain certain records related to the Proposed Rules discussed above.

Proposed Changes for All Investment Advisers (Registered and Unregistered)

- *Preferential Treatment Rule.* Proposed Rule 211(h)(2)-3 would prohibit registered and unregistered investment advisers (including SEC-registered investment advisers, SEC and state exempt reporting advisers, state-registered investment advisers, and any other investment advisers not registered with the SEC) from offering

preferential terms to certain private fund investors (regarding redemptions from the fund or information about portfolio holdings or exposures) if the investment adviser reasonably expects those terms to have a material, negative impact on other investors. In addition, the Proposed Rules would prohibit investment advisers from providing any other preferential treatment unless such treatment is disclosed to all other investors in the private fund.

This provision would greatly affect investment advisers' use of "side letters." Specifically, the SEC stated that mere disclosure that some investors pay a lower fee than others in exchange for a significantly higher capital contribution than paid by others is not specific enough. The SEC stated that the adviser must describe the lower fee terms, including the applicable range in order to provide specific information required by the Proposed Rules. An investment adviser could comply with this disclosure requirement by providing copies of side letters or a written summary of the preferential terms provided to other investors in the same private fund. Without a "grandfathering" provision, this provision would force advisers to choose between complying with the new Proposed Rules or breaching a previously granted side letter provision.

- *Prohibited Activities Rule.* Proposed Rule 211(h)(2)-1 would prohibit registered and unregistered investment advisers (including SEC-registered investment advisers, SEC and state exempt reporting advisers, state-registered investment advisers, and any other investment advisers not registered with the SEC) from (i) charging certain fees and expenses to private funds or its portfolio investments, such as fees for unperformed services (e.g., accelerated monitoring fees); (ii) 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 fund; (iii) charging the fund for fees associated with a government examination or investigation as well as for regulatory or compliance fees or expenses; (iv) charging fees to reduce the amount of any investment adviser clawback by the amount of certain taxes; (v) charging fees or expenses related to a portfolio investment on a non-*pro rata* basis; and (vi) borrowing or receiving an extension of credit from a private fund client.

Conclusion

The SEC's new proposals have the potential to significantly affect private fund investment advisers and private funds, forcing investment advisers to private funds to think about future compliance issues. We emphasize that these Proposed Rules have only been proposed at this stage and are still subject to public comment before any final rules are adopted. We expect many comments to be submitted. The SEC is proposing a one-year transition period after final rules are adopted to provide time for investment advisers to come into compliance with the Proposed Rules.

For additional information on how these proposals might affect your firm or practice, please contact Paul Foley, Chair, John Faust, Kiki Scarff, Bree Ward, or Brittany Puckett, each of Akerman's Investment Management Practice.
