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SEC PROPOSES SWEEPING NEW AND AMENDED RULES UNDER ADVISERS ACT TO OVERHAUL PRIVATE FUND INDUSTRY

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In the span of two weeks, the US Securities and Exchange Commission (SEC) has proposed rules that would significantly overhaul the regulation of the private fund industry. Specifically, on January 26, the SEC issued proposed amendments to Form PF reporting requirements for certain private fund managers and, on February 9, proposed new and amended rules under the Investment Advisers Act of 1940 that, if adopted, would impose new SEC and investor reporting requirements on certain private fund advisers.

The SEC approved the proposals despite strong dissents issued by Commissioner Hester Peirce, who voted no on each proposal and raised concerns that the rules would take away the SEC's resources from protecting retail investors. Chairman Gary Gensler, however, indicated that he views the rules as protecting retail investors whose retirement plans invest in private funds.

SEC PROPOSES TO AMEND FORM PF TO ENHANCE SYSTEMIC RISK MONITORING

Overview of Proposed Rules

In an effort to enhance the Financial Stability Oversight Council's (FSOC's) monitoring and assessment of systemic risk and to protect investors, the SEC has proposed to transform Form PF into a current reporting form for large hedge fund advisers and advisers to private equity funds, while maintaining the existing quarterly or annual reporting obligations applicable to private fund advisers regardless of size. The SEC's proposal also (1) expands Section 4 of Form PF by reducing the reporting threshold applicable to large private equity advisers from $2 billion to $1.5 billion in private equity fund assets under management; and (2) introduces a new large liquidity fund adviser reporting requirement that essentially requires such advisers to report the same information that money market funds report on Form N-MFP (as proposed to be amended in December 2021). [1]

New Current Reporting for Large Hedge Fund Advisers and Advisers to Private Equity Funds

The existing Form PF does not require current reporting. Rather, large hedge fund advisers file Form PF quarterly and private equity advisers (and other private fund advisers) file Form PF annually. The SEC believes that this

information is stale during fast-moving events, and has proposed current reporting **due within one business day** of the triggering event to allow the SEC and FSOC to assess the event's potential impact on investors and the financial system and whether regulatory responses are appropriate.

The proposed rules would increase the compliance burden for private fund advisers, particularly because the one business day reporting period would require real-time monitoring and testing. Not only would policies and procedures need to be updated, but systems would need to be updated to reflect the current reporting requirements. With limited time to submit a report after the occurrence of a triggering event, compliance with the reporting requirement may strain resources that could be used to address a triggering event at critical times for a fund. To the extent that a private fund investor makes a current report, SEC scrutiny may ensue. Moreover, private fund advisers are required to submit Form PF only to the SEC, but investors may inquire about it during due diligence processes. The implications of the proposed rules are far-reaching, but not fully known at this point. As discussed below, triggering events differ depending on whether the adviser is an adviser to a large hedge fund or a private equity fund.

Nine Triggering Events for Large Hedge Fund Advisers

1. Extraordinary investment losses: Triggered by a loss equal to or greater than 20% of a fund's most recent net asset value over a rolling 10 business day period. Examples would include a fund with a net asset value of $1 billion that loses $20 million per business day for 10 consecutive business days or, alternatively, a loss of $200 million in one business day. The report would be required to include the dates the loss occurred and the dollar amount of the loss. Multiple reports could be necessary after the end of a 10-business-day period.

2. Margin increases: Triggered by a cumulative increase in margin of more than 20% of the reporting fund's most recent net asset value over a rolling 10-business-day period, even if the increase results from regulatory requirements. The report would be required to include the dates of the 10-business-day period over which the increase occurred, the cumulative dollar amount of the increase, and the identity of the counterparty or counterparties requiring the increase. The adviser would also have to identify the circumstances of the margin increase, for example:

- exchange requirements or known regulatory action affecting a counterparty;
- a counterparty independently increasing the reporting fund's margin requirements;
- the reporting fund establishing a new relationship or new business with a counterparty;
- ·new investment positions, investment approach, or strategy and/or portfolio turnover of the reporting fund;
- a deteriorating position or positions in the reporting fund's portfolio or other credit trigger under applicable counterparty agreements; and/or
- a reason "other" than those outlined above.

3. Margin defaults: Triggered by a fund's margin default or inability to meet a call for margin. The report would be required to include the date of the margin default, the dollar amount of the margin involved, and the legal name and any legal entity identifier (LEI) of the counterparty, as well as the circumstances of the default (i.e., increased counterparty requirements, losses in the value of the portfolio or other credit trigger, a counterparty's default or settlement failure, or "other" reason). Multiple reports could be necessary after the end of a 10-business-day period.

4. Counterparty defaults: Triggered if a counterparty to the reporting fund (1) does not meet a call for margin or has failed to make any other payment, in the time and form contractually required (taking into account any contractually agreed cure period); and (2) the amount involved is greater than 5% of the most recent net asset

value of the reporting fund. The report would be required to include the date of the default, the dollar amount of the default, and the counterparty's legal name and any LEI.

5. Material changes in prime broker relationships: Triggered by material changes to the fund's ability to trade or an outright termination of the prime brokerage relationship for default or breach of the prime brokerage agreement. The report would be required to include whether the change involved: (1) material trading limits or investment restrictions on the reporting fund, including requests to reduce positions, or unwind positions completely; and (2) termination of the prime brokerage relationship (and which party terminated that relationship).

6. Changes in unencumbered cash: Triggered if the value of the reporting fund's unencumbered cash declines by more than 20% of the reporting fund's most recent net asset value over a rolling 10-business-day period. The report would be required to include the last day of the rolling 10-business-day period during which the unencumbered cash declined and the dollar amount of the unencumbered cash on the last day of the period, as well as whether: (1) the change was attributable to redemption activity for the fund; (2) the change was attributable to new investment positions, strategy and/or portfolio turnover; (3) the change was related to losses in the value of the fund's portfolio; (4) the change was related to a margin call; or (5) the change was caused by a reason "other" than those outlined. Multiple reports could be necessary after the end of a 10-business-day period.

7. Operations events: Triggered when the adviser or reporting fund experiences a "significant disruption or degradation" (a 20% disruption or degradation of normal volume or capacity) of the reporting fund's "key operations" (operations necessary for the (1) investment, trading, valuation, reporting, and risk management of the reporting fund; and (2) operation of the reporting fund in accordance with federal securities laws and regulations. The report would be required to include an indication of whether the event occurred at a service provider or at a reporting fund or reporting fund adviser or a related person, or if the event is related to a natural disaster or other force majeure event.

The report also would need to describe whether the event resulted in the disruption or degradation of (1) the trading of portfolio assets; (2) the valuation of portfolio assets; (3) the management of the reporting fund's investment risk; (4) the ability to comply with applicable laws, rules, and regulations; or (5) any "other" type of operational impact than those outlined.

8. Redemptions in excess of 50% of the fund's net asset value: Triggered when an adviser receives cumulative requests for redemption exceeding 50% of the most recent net asset value (after netting against subscriptions and other contributions from investors received and contractually committed).

The report would be required to include (1) the date of occurrence; (2) the net value of redemptions paid from the reporting fund between the last Form PF reporting date and the date of the current report, as the percentage of the fund's net asset value that the redemption requests represent; and (3) whether the adviser has notified investors that the fund will liquidate.

9. Inability to satisfy redemptions: The current report would also be triggered when a qualifying hedge fund is unable to satisfy redemptions or suspends redemptions for more than five consecutive business days.

The report would be required to include (1) the date of occurrence; (2) the percentage of redemptions requested and not yet paid; and (3) whether the adviser has notified investors that the fund will liquidate.

Three Triggering Events for Advisers to Private Equity Funds

1. Execution of an adviser-led secondary transaction

- The SEC proposes to define an adviser-led secondary transaction as any transaction initiated by the adviser or any of its related persons that offers private fund investors the choice to (1) sell all or a portion of their interests in the private fund; or (2) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.
- The SEC is expressing an interest in reporting adviser-led secondary transactions and, together with the proposed fairness opinion requirement noted below, this interest may be an indication of increased SEC scrutiny and regulation of these transactions.

2. Implementation of a general partner or limited partner clawback

- A general partner clawback would be defined as any obligation of the general partner, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the fund pursuant to the fund's governing agreements.
- A limited partner clawback would be defined as an obligation of a fund's investors to return all or any portion of a distribution made by the fund to satisfy a liability, obligation, or expense of the fund pursuant to the fund's governing agreements. The proposal requires reporting for limited partner clawbacks in excess of an aggregate amount equal to 10% of a fund's aggregate capital commitments.

3. Removal of a fund's general partner, termination of a fund's investment period, or termination of a fund

The proposal would require an adviser to report when a fund receives notification that fund investors have (1) removed the adviser or an affiliate as the general partner or similar control person of a fund; (2) elected to terminate the fund's investment period; or (3) elected to terminate the fund, in each case as contemplated by the fund documents.

SEC INTRODUCES AN INVESTOR REPORTING AND INVESTMENT ADVISER DOCUMENTATION PROPOSAL TO PROTECT PRIVATE FUND INVESTORS

The SEC's appetite to enhance regulations applicable to private fund advisers does not end at Form PF. Two weeks after proposing the Form PF amendments, the SEC introduced another proposal to add new and amended rules under the Investment Advisers Act that the SEC believes would increase transparency and avoid adviser conflicts of interest.[2] If adopted as proposed, a private fund adviser would need to adopt policies and procedures to comply with these requirements and evaluate whether its governing documents, offering memoranda, and side letters should be updated to reflect the new regulatory requirements and prohibitions. The proposed rules apply to exempt reporting advisers in some instances, but the SEC has posed questions for comment asking whether other parts of the proposed rules should apply to such advisers. The proposed rules have the potential to significantly increase regulatory burdens across registered and exempt private fund advisers. A high-level summary of this proposal as follows:

Quarterly Reporting

Currently, private fund advisers are not subject to investor reporting requirements under the Investment Advisers Act. The proposed rules would require a registered private fund adviser to prepare a quarterly statement for each private fund that it advises (directly or indirectly) that has at least two full calendar quarters of operating results.

Within 45 days of the calendar quarter end, the adviser would be required to distribute a quarterly statement to investors, unless the quarterly statement is prepared and distributed by another person. The quarterly statement would be required to include: a fund table, a portfolio investment table, prominent disclosure,

performance data regarding whether the fund is a liquid or illiquid fund, and consolidated reporting to cover substantially similar pools of assets if meaningful.

Private fund advisers that are registered with the US Commodity Futures Trading Commission (CFTC) as commodity pool operators (CPOs) are subject to quarterly account statement requirements with respect to pools operated pursuant to CFTC Rule 4.7. The SEC acknowledged that private fund advisers may be subject to a requirement that is duplicative with its proposal, and requested comment on potential overlap between the proposed quarterly statement and the existing quarterly account or similar statements currently prepared by advisers.

Private Fund Audit Rule

Registered private fund advisers would be required to obtain an audited financial statement of each private fund annually and upon liquidation (similar to the custody rule), and distribute the audited financial statements to investors "promptly" after the audit's completion. In addition, a fund's auditor would be required to notify the SEC upon the auditor's termination or issuance of a modified opinion. The CFTC has similar requirements, but its regulations impose a timeline for distribution (90 days of the pool's fiscal year end) and further require a CPO to file the annual report containing audited financial statements with the National Futures Association.

Adviser-Led Secondaries Rule

With respect to an adviser-led secondary transaction, a registered private fund adviser would be required to provide to investors a fairness opinion from an independent opinion provider and 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 SEC has proposed to define "adviser-led secondary transaction" as any transaction initiated by the investment adviser or any of its related persons that offers private fund investors the choice to (1) sell all or a portion of their interests in the private fund; or (2) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. Under this definition, continuation funds would be captured, but not tender offers outside of a continuation fund context.

The SEC believes that a fairness opinion provides "an important 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." Many, but not all, adviser-led secondary transactions already involve fairness opinions. While fairness opinions are sometimes not provided when other third-party comparable or marks are available or when there is an auction process, this rule would mandate them for all adviser-led secondary transactions under this rule.

Prohibited Activities

In what would be a significant change to the approach of how private funds are regulated, under the proposed rules, **all advisers to private funds**—regardless of whether they are registered with the SEC or pursuant to state law, exempt reporting advisers, or prohibited from registration—would be prohibited from engaging in certain sales practices, conflicts of interest, and compensation arrangements. The proposed rules would prohibit advisers from charging private funds certain fees or expenses, among other new prohibitions. The current approach to regulation generally permits these activities provided that the adviser discloses the activities to investors prior to its subscription. The proposed rules would prohibit all private fund advisers from:

- Charging the following fees and expenses to a private fund or portfolio investment: accelerated monitoring fees; fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities; regulatory or compliance expenses or fees of the adviser or its related

persons; or 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;
- Reducing the amount of any adviser clawback by the amount of certain taxes;
- 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
- Borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client.

Each of these prohibitions presents a change to existing market standard practices, as noted by the below examples:

- The proposed prohibition on charging certain fees and expenses to a private fund may cause certain advisers to reevaluate current assumptions and pricing models. For instance, the prohibition includes certain fees and expenses associated with "related persons," a term broadly defined by the SEC without clarification of whether the private fund itself is captured by this term. Under the proposed "related person" definition, a private fund might be captured depending on its legal form or the amount of the adviser's capital contributed, as all persons controlled by the adviser would be deemed to be "related persons." In addition, the prohibition on charging regulatory expenses to a private fund could limit the ability of an adviser to charge Form PF-related expenses to the fund (which may increase as a result of the aforementioned rule changes), even though Form PF relates to the fund. Furthermore, as managers would not be able to charge expenses 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*), they may be required to reconsider how broken deal expenses are allocated, including with respect to co-investments.
- The proposed prohibition on calculating any GP-clawback on a net-of-taxes basis is very broad and may require general partners to repay more carried interest distributions than they actually have received on an after-tax basis.
- The proposed rules would restrict a private fund adviser from seeking indemnity for negligence whereas most fund governing documents currently permit indemnity for negligence as long as it is not gross negligence.

If the proposed rule is adopted, managers will need to review their expense and indemnification policies and practices to ensure compliance with the rule and may be required to update their legal documents generally.

Side Letters and the Prohibition of Preferential Treatment

All advisers, whether registered or exempt, would be prohibited from providing preferential terms to certain investors regarding redemption or portfolio holdings or exposures information. Other preferential treatment may only be provided to investors if the adviser provides written disclosures of such preferential treatment to prospective and current investors. The SEC also explains that terms that are considered preferential depend on the facts and circumstances.

The proposed rules could significantly impact side letter practice. The SEC acknowledges that some investors would find it difficult to secure preferential terms but goes on to state that the types of preferential treatment that the proposed rules would prohibit are "contrary to the public interest and protection of investors."

Annual Review of Compliance Program

Under the proposed rules, registered investment advisers would be subject to a requirement to document, in writing, the annual review of their compliance policies and procedures. Such documentation would allow SEC staff to determine whether the adviser has complied with the SEC's compliance rule (*see* Rule 204-2(a)(17)).

Other Proposed Rulemakings

There are several other relevant proposed rulemakings that the SEC issued during this time period, including amendments to Regulation ATS; cybersecurity risk management rules for investment advisers, registered investment companies, and business development companies; amendments to the securities transaction settlement cycle rules; and beneficial ownership reporting amendments. Watch for upcoming LawFlashes on the amendments to the beneficial ownership reporting rules and Regulation ATS.

WHAT'S NEXT?

The proposals represent a significant overhaul of the private fund industry's regulatory regime. Not only would the current report obligations under the proposed amendments to Form PF impose new, burdensome compliance monitoring and reporting obligations on the private fund industry, but the investor reporting proposal would cause advisers to rethink how they charge funds for certain fees and expenses and how they report to investors.

The SEC has provided a short comment period of 30 days from publication in the Federal Register for the Form PF proposal and the longer of 30 days from publication in the Federal Register and 60 days from February 9 for the investor reporting and documentation proposal. Those who wish to comment should do so soon.

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[1] Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, Release No. IA-5950 (Jan. 26, 2022). Definitions of pertinent terms include:

- A **large hedge fund adviser** is an adviser that has at least $1.5 billion in regulatory assets under management attributable to hedge funds as of the end of any month in the prior fiscal quarter.
- A **large private equity adviser** is an adviser having at least $2 billion (proposed to be reduced to $1.5 billion) in regulatory assets under management attributable to private equity funds as of the last day of the adviser's most recently completed fiscal year.
- A **large liquidity fund adviser** is an adviser that manages a liquidity fund and that has at least $1 billion in combined regulatory assets under management attributable to liquidity funds and registered money market funds as of the end of any month in the prior fiscal quarter.
- A **hedge fund** is broadly defined to include any private fund (other than a securitized asset fund) that has any of the following three characteristics: (1) a performance fee or allocation that takes into account unrealized gains; (2) a high leverage (i.e., the ability to borrow more than half of its net asset value, including committed capital, or have gross notational exposure in excess of twice its net asset value, including committed capital); or (3) the ability to short sell securities or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration). Non-exempt commodity pools that an investment adviser is required to report are automatically categorized as hedge funds. Vehicles established for the purpose of issuing asset-backed securities are excluded from the "hedge fund" definition in Form PF.

- A **private equity fund** is private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course. However, private funds that have the ability to borrow or short securities have to file as a hedge fund.
- A **liquidity fund** is any private fund that seeks to generate income by investing in a portfolio of short-term obligations in order to maintain a stable net asset value or minimize principal volatility for investors.

[2] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release No. IA-5955 (Feb. 9, 2022).

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