KIRKLAND & ELLIS

Kirkland AIM

SEC Proposes Sweeping Rule Changes for Private Fund Advisers (Part 2 of 2)

18 February 2022

As summarized in a previous *Kirkland AIM*, on February 9, 2022, the SEC voted 3-1 to propose significant new rules[1] under the Investment Advisers Act of 1940 (the "Advisers Act") to increase the regulation of investment advisers, including private fund[2] advisers (the "Proposed Rules").

The Proposed Rules represent the most extensive rulemaking applicable to private fund advisers by the SEC under Chairman Gensler, as well as the SEC's most emboldened use to date of authorizing provisions under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[3] the original rulemaking requiring most large private fund advisers to register under the Advisers Act during the 2011-2012 period. If adopted in their current form, the Proposed Rules would represent a departure from statements in recent years by the SEC and its Staff[4] emphasizing disclosure of adviser practices, and result in a rare imposition of substantive requirements and prohibitions on private fund advisory contracts (e.g., limited partnership agreements and investment management agreements), particularly without express statutory authority regarding those requirements or prohibitions.

Because the Proposed Rules do not contain any grandfathering provisions, if adopted in their current form they would apply to existing negotiated governing agreements and contractual arrangements, in addition to those entered into following the effective date of the Proposed Rules. In many cases, as outlined below, the substantive requirements and prohibitions would apply not only to SEC-registered advisers, but also to U.S. and non-U.S. private fund advisers that rely on the SEC's "exempt reporting adviser" exemptions for mid-sized private fund advisers, venture capital fund advisers, smaller advisers and foreign private advisers.

This alert provides a detailed review of the Proposed Rules.

Quarterly Statements

The Proposed Rules would require an SEC-registered adviser to prepare and deliver to its private fund investors a quarterly statement for each private fund[5] within 45 days of the end of each calendar quarter, with the first statement due following the second full calendar quarter of the fund's operational results. Each statement must be presented in a standardized format and delivered in addition to (or incorporated in) any negotiated reporting requirements already in the fund's governing documents, and must include:

- a fund-level table detailing:
  - all forms of compensation[6] paid or allocated to the adviser or any of its related persons[7] from the private fund during the reporting period;
  - fees and expenses[8] paid by the private fund during the reporting period; and
  - the amount of any offsets, rebates or waivers carried forward during the reporting period for subsequent periods.

  Each form of compensation or each category of fees or expenses must be shown as a separate line item detailing the corresponding amount paid. The table must also report the dollar amount of each category of expense before and after any offset, rebate or waiver provisions in the fund's governing documents are applied;
- a table of any "portfolio investments"[9] that allocate or pay compensation to the adviser or its related persons detailing:
  - the private fund's share of all compensation[10] allocated or paid by each such portfolio investment to the adviser or its related persons during the reporting period, with each form of compensation shown as a separate line item detailing the total amount paid, and presented both before and after the application of any offsets, rebates or waivers; and
  - the private fund's ownership percentage of each "covered portfolio investment" as of the end of the reporting period.[11] The definition of "covered portfolio investment" picks up below-the-fund holding companies, intermediate entities and special purpose vehicles formed to effect the fund's investment, but only to the extent that such entities allocate or pay compensation to the adviser or its related persons during the reporting period; and

- performance reporting that varies by type of fund, calculated as of the most recent practicable date[12]:
  - for illiquid funds[13] such as most private equity funds:
    - gross and net internal rate of return ("IRR") and gross and net multiple of invested capital ("MOIC") for the full fund portfolio since inception;

    - gross IRR and gross MOIC for the realized portion of the fund's portfolio and the unrealized portion of the fund's portfolio since inception, shown separately;
    - aggregate contributions and distributions since the fund's inception; and
    - a statement of the fund's net asset value; and
  - for all other funds, which the Proposed Rules term "liquid funds":
    - annual net total returns for each calendar year since inception; and
    - average annual net total returns over the one-, five-, and ten- calendar year periods.

The SEC contemplates a "detailed accounting" for the required information and anticipates, for example, that the quarterly statement includes sufficient detail to enable a private fund investor to verify that the categories of expenses conform to the fund's governing agreements.[14] Each quarterly statement must include prominent disclosures regarding the manner in which expenses, payments, allocations, rebates, waivers and offsets are calculated, together with cross-references to organizational and offering documents setting forth those calculation methodologies, although the Proposed Rules include limited discussion on the required form, level of detail or other aspects pertaining to this requirement.

With respect to their performance requirements, the Proposed Rules would mandate uniform definitions of performance metrics like IRR and MOIC, noting the SEC's intention to standardize the calculations and limit adviser deviations to promote comparability of adviser performance data. Advisers would also be required to calculate and present performance information without the impact of fund-level subscription facilities or similar arrangements.[15] However, the Proposed Rules would permit an adviser to include other information alongside the mandated performance information (e.g., performance metrics under the adviser's historical methodologies, presumably including performance with the impact of fund-level subscription facilities), so long as it is no more prominent than the required information.

The Proposed Rules also require the inclusion of prominent disclosures addressing the criteria used and assumptions made in calculating the performance. As an example, the SEC notes that advisers would be expected to clarify the fee rate used for calculating net performance metrics (e.g., whether it was a blended rate, a weighted average or how it was otherwise derived and whether it factored in discounted fee investors). Advisers who are unable to gather the performance data for the immediately preceding quarterly period would be permitted to calculate the information as of the most recent practicable date (which the Proposal notes generally would be the quarter-end prior to the immediately preceding quarter).

Annual Audits

Citing to the SEC's concern with misappropriation of private fund assets, as well as what it views as advisers' opportunistic valuation practices, the Proposed Rules require an SEC-registered adviser to obtain from an independent public accountant an annual audit of the financial statements of all of its managed or advised funds. The audit would be required to be:

- performed by an independent public accountant;[16]
- performed at least annually and upon liquidation;[17]
- in accordance with Generally Accepted Accounting Principles as promulgated in the United States ("U.S. GAAP"), or for financial statements of non-U.S. funds or funds with a general partner with a principal place of business outside the U.S., contain information substantially similar to statements prepared in accordance with U.S. GAAP and with any material differences reconciled; and
- distributed "promptly" after completion of the audit to current private fund investors, although the term is not defined by the Proposed Rules.

A written agreement between the adviser or the private fund and the independent public accountant must require that the accountant 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 Proposed Rules' audit requirement is separate and distinct from the Custody Rule, Rule 206(4)-2 under the Advisers Act, and in proposing a largely duplicative (but not overlapping) set of audit requirements the SEC notes that not all private fund advisers are subject to the Custody Rule and even those that are subject to the Custody Rule are not required to obtain an audit in order to comply with the rule. As a result, Custody Rule compliance would not necessarily guarantee compliance with the Proposed Rules, and *vice versa.* Unlike under the Custody Rule regime, the Proposed Rules do not provide for the option of a surprise examination in lieu of an audit, nor do they provide for certain exceptions permitted under the Custody Rule for advisers who do not have "custody." Further, the Proposed Rules impose stricter standards on non-U.S. sponsors than previous Custody Rule guidance, as they do not permit U.S. GAAP reconciliations to be provided solely to U.S. person investors.

The Proposed Rules do provide certain leniency for private funds not controlled by or under common control with the adviser (e.g., a sub-adviser is unaffiliated with the fund). In these narrow cases, an adviser must merely "take all reasonable steps" to cause its private fund client to undergo an audit. However, this exception likely would not be available where the adviser is primary adviser to a private fund, even where such adviser is not the general partner or affiliated with the general partner.

Under the Proposed Rules, advisers would also need to maintain a copy of any audited financials and a record of each addressee and date sent, address and delivery method, codifying the expressed preference of SEC Staff on recent examinations of SEC-registered advisers.

Secondary Transactions

The SEC notes that investment advisers have become increasingly active in the secondary market and its belief that secondary transactions raise certain conflicts of interest. The Proposed Rules accordingly require that any SEC-registered adviser seeking to complete an "adviser-led secondary transaction"[18] with respect to a sponsored private fund must first distribute to the selling fund's investors a written:

- third-party opinion stating the price being offered to the private fund for any assets being sold in the transaction is fair; and
- summary of any material business relationships[19] between the fairness opinion provider and the adviser or its related persons within the past two years.

The provider of the fairness opinion must not be related to the adviser and must provide fairness opinions in the ordinary course of its business, and therefore have expertise in valuing illiquid and esoteric assets based on relevant criteria.

To facilitate monitoring of compliance with this Proposed Rule, the SEC would require investment advisers to keep a copy of any fairness opinion and material business relationship summary distributed under the new rule, along with a record of each addressee and the corresponding dates sent, addresses and delivery methods used.[20]

Prohibited Activities

The Proposed Rules include an outright ban on certain activities of an investment adviser, directly or indirectly, with respect to a private fund and investors in a private fund,[21] which the SEC believes could result in fraud or financial harm and purportedly "incentivize investment advisers to place their interests ahead of their clients' (and by extension their investors')" and cause funds and investors to bear an unfair proportion of fees and expenses. The proposed outright ban on these activities means that notwithstanding prior disclosure to investors, authorization in fund governing documents or approval of limited partner advisory boards, the specified activities of any investment adviser would be unlawful under the Advisers Act.

Unlike the new quarterly reporting, annual audit and secondary transactions proposed rules, the proposed prohibited activities apply both to SEC-registered advisers and other advisers not registered under the Advisers Act, such as exempt reporting advisers (e.g., mid-sized private fund advisers, venture capital advisers or certain non-U.S. advisers)[22] and investment advisers not required to register with the SEC (e.g., foreign private advisers or advisers generally with AUM under $100 million).[23]

- *Charging Certain Fees to Portfolio Investments.* The Proposed Rules would prohibit an investment adviser to a private fund to charge a portfolio investment for monitoring, servicing, consulting or other fees ("Supplemental Fees") in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment. The proposed ban on such compensation clearly is intended to target accelerated monitoring fees, but also implicates other fee arrangements. The SEC notes that (1) the prohibition does not restrict the adviser from receiving Supplemental Fees for services actually performed, (2) charging Supplemental Fees in advance of services so long as services are, or are reasonably expected to be, performed with the adviser making a prorated refund of Supplemental Fees in the event services are not actually performed, and (3) the prohibition would not apply if the adviser applied a 100% management fee offset for Supplemental Fees received by the adviser.[24] The proposed ban on Supplemental Fees for services not provided is likely to create additional pressure on advisers to justify the level of services performed for Supplemental Fees in connection with SEC examinations.
- *Charging Examination/Investigation Fees or Expenses.* The Proposed Rules would prohibit an investment adviser to a private fund from charging the private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any government or regulatory authority. While the Proposing Release notes that the SEC does not anticipate this rule will result in a dramatic change for investment advisers to private funds, the requirement is not limited to SEC-registered adviser examination or investigations and broadly applies to any governmental or regulatory authority. Coupled with the Proposed Rules' indirect prohibitions could pick up state inquiries into fund "blue sky" filings or securities offerings, or portfolio investment examinations or investigations, which in many instances should be appropriate to be paid by the portfolio investment or fund to the extent the adviser or its personnel become involved.
- *Charging Regulatory or Compliance Fees or Expenses.* The Proposed Rules would prohibit an investment adviser to a private fund from charging the private fund any

regulatory fees or expenses ("Compliance Costs") of the adviser or its related persons. However, the Proposing Release notes that the adviser may charge private funds for regulatory, compliance and similar fees and expenses directly related to the activities of the private fund (e.g., Form D-related fees and expenses) if adequately disclosed and authorized under fund governing documents, and for mixed items involving both the fund and adviser, permits the adviser to make a "fair and equitable" allocation consistent with its fiduciary duty to clients. A limited number of U.S. private fund advisers charge certain of these Compliance Costs to their funds (e.g., smaller or start-up advisers who would be required to bear such items under these requirements); however, the Proposed Rules would have broader implications for advisers whose marketing activities on behalf of the fund in non-U.S. jurisdictions require a "passport" or similar registration for an adviser entity.

- *Reducing any Adviser/GP Clawback for Taxes.* The Proposed Rules would prohibit an investment adviser to a private fund from reducing the GP clawback by any actual, potential or hypothetical taxes applicable to the adviser or its related persons or owners. A clawback subject to the rule is defined as any obligation of the adviser, its related persons (e.g., a private fund GP) or owners to restore or otherwise return any performance-based compensation to the private fund under its governing documents. Because the Proposed Rules would apply to existing fund agreements after the proposed 1-year transition period, this provision could be particularly onerous for GPs in a clawback position.

  The Proposed Rules do not require that all private funds include a clawback provision, and so mandating that clawbacks be calculated on a pre-tax basis amounts to a requirement to make a historically optional investor-favorable provision even more investor-favorable. The proposed change would override the standard, nearly universal in private funds, that GP clawbacks are reduced for taxes (either actual taxes or notional taxes determined using commonly accepted and agreed tax rate assumptions) paid or deemed paid by the GP or its owners on the relevant performance-based compensation. Because tax losses (if any) recognized by an adviser or its related persons in connection with a clawback payment are generally subject to substantial limitations, including in most cases a prohibition on carrying back such tax losses, the Proposed Rules will in many cases put advisers in a worse after-tax position than if no performance-based compensation had been charged at all. Concerningly, the SEC acknowledged this possibility in a Proposing Release footnote.
- *Indemnities/Exculpation.* The Proposed Rules would prohibit an investment adviser to a private fund from 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. On its face, this appears to seek to apply a strict liability standard for private fund advisers.

Private funds historically have negotiated exculpation and indemnity provisions with sophisticated investors in fund governing documents, striking a balance between investor interests and an adviser implementing a wide-ranging investment program. In the private equity context, this often involves managing underlying companies, projects or other complex investments on behalf of fund investors. Less than three years ago, the SEC stated in its formal interpretation of an adviser's fiduciary duties under the Advisers Act[25] that whether these indemnity/exculpation clauses were inconsistent with an adviser's fiduciary duties to an institutional client depends on all the facts and circumstances relating to the adviser's client relationship and the sophistication of the client and cited only certain limited provisions as being inconsistent with the Advisers Act, namely: (1) a statement that the adviser will not act as a fiduciary; (2) a blanket waiver of all conflicts of interest; or (3) a waiver of any specific obligations of an adviser under the Advisers Act, in addition to non-waivable rights under state or federal law. The prohibition under the Proposed Rules is not limited in this manner and appears to broadly apply not only to securities laws, such as the Advisers Act, but state and potentially other fiduciary duties, which are frequently alleged to be implicated in the context of portfolio company litigation.

It should be noted that the proposal does apply to direct or indirect actions by the adviser but does not expressly cover "related persons" (e.g., adviser personnel or control affiliates) like certain other prohibitions described above. The scope of the proposed rule as drafted, however, is unclear and under a broad reading could potentially extend to adviser control affiliates, portfolio investments or even insurance premiums, and presents a broad disruption of longstanding arrangements. If adopted in their current form, the Proposed Rules in this area could face significant challenge.

- *Certain Non-Pro Rata Fee and Expense Allocations.* The Proposed Rules would prohibit an adviser from charging or allocating fees and expenses related to a portfolio investment (or proposed portfolio investment) on a non-*pro rata* basis when multiple private funds and other clients of the adviser have invested (or proposed to invest) in the same portfolio investment. The proposed rule is designed to address potential conflicts of interest an adviser can face where multiple funds invest in the same portfolio investment, notably in those instances where an adviser has an incentive to allocate fees and expenses among its funds in a way that maximizes its own compensation.

  Of particular note, the SEC's proposed rule, if adopted, would treat fees and expenses attributable to unconsummated investments (or “broken deal” expenses) the same as fees and expenses with respect to consummated investments. Accordingly, if more than one fund would have participated in an investment that generated “broken deal” or other fees and expenses, the SEC’s view is that all such funds (regardless of strategy) should bear their *pro rata* share of such amount.[26] Importantly, however, the Proposing Release concedes that to the extent a potential co-investor has not executed a binding agreement to participate in the transaction through a co-investment vehicle (or another fund) managed by the adviser, the proposed rule would not prohibit the adviser from allocating “broken-deal” or other fees and expenses attributable to such potential co-investor to a fund that would have participated in the transaction, so long as the practice is authorized by the fund’s governing documents.

- *Borrowing from a Private Fund Client.* The Proposed Rules would prohibit an adviser from borrowing money, securities or other fund assets, or receiving a loan or an extension of credit, from a private fund client. The SEC notes its concern that, when an adviser borrows from a fund client, the adviser has a conflict of interest because it is on both sides of the transaction. Although the proposal would not prevent the adviser from borrowing from a third party on the fund’s behalf or from lending to the fund, notably including the use of subscription lines of credit to address financing needs, a number of interpretive considerations remain. For example, many private fund governing documents characterize certain amounts paid to the general partner as loans, rather than distributions, for tax purposes; the proposal would appear to implicate these practices. Additionally, in light of the Proposed Rules’ “direct or indirect” prohibitions, a question remains whether the SEC would prohibit financial institutions that are (or that are affiliated with) limited partners in a private fund from lending to the adviser or its personnel in ordinary commercial arrangements.

Preferential Treatment

In an effort to address specific types of “preferential treatment” the SEC believes have a material negative effect on investors in a fund, the Proposed Rules impose an outright prohibition on private fund side letters or similar arrangements (“Side Letters”) that would:

- permit an investor to redeem its interest in a private fund or in a “substantially similar pool of assets”[27] (a “Similar Vehicle”); or
- provide information regarding the portfolio holdings or exposures of the private fund, or of a Similar Vehicle;

in either case, where the adviser reasonably expects the enhanced redemption or information rights to have a material, negative effect on other investors in that private fund or in the Similar Vehicle. The SEC's proposal leaves advisers to weigh the examination and enforcement risks of whether enhanced reporting for tax purposes or to fulfill an investor's bespoke internal information requirements will have a "material, negative effect" on other investors. Without a "grandfathering" provision, the Proposed Rules provide implementational challenges for advisers who will be required to choose between attempted compliance with the new regime and a breach of a previously granted side letter provision. Many private fund Side Letters provide limited redemption rights when an investor would otherwise exceed a specified ownership threshold with particular tax or regulatory ramifications to the investor, and these Side Letters may be implicated by the Proposed Rules' prohibitions.

With respect to other Side Letter terms, the Proposed Rules do not outright prohibit, but require written disclosures to prospective and current investors, including for example: excuse rights; fee discounts; or the right to increase an investment in a private fund. The SEC notes its belief that it would be insufficient under the Proposed Rule for an adviser simply to disclose that some investors pay a lower fee. Instead, an adviser would be required to describe the lower fee terms, including the applicable rate or range of rates, in order to provide sufficiently specific information pursuant to the Proposed Rules. Alternatively, an adviser could comply with the proposed requirements by providing copies of Side Letters (with identifying information regarding the investors redacted) or a written summary of the preferential terms provided to investors, so long as the summary specifically describes the preferential treatment. Implementational challenges will remain for sponsors who intend to keep their disclosures on granted side letter terms current for the other investors that are part of each fund closing.

SEC-registered advisers will be required under the Proposed Rules to retain copies of all written notices sent to current and prospective investors in a private fund to support their compliance with the proposed preferential treatment rule.

Annual Review of Compliance Policies

Finally, the Proposed Rules require all SEC-registered advisers (including those that do not advise private funds) to document the annual review of their compliance policies and procedures in writing. Although many advisers already prepare written annual reviews as a widely adopted "best practice," the current text of the compliance rule, Advisers Act Rule 204A-1, currently does not require it. The SEC believes the proposed amendment would allow the SEC's Staff better to determine whether an adviser has complied with the annual review requirement of the compliance rule by assessing the results of such review in a written document, and the Proposed Rules match longstanding SEC examination expectations.

Transition Period

A public comment period will remain open for both Proposed Rules for 60 days following the publication of the proposing releases on the SEC's website on February 9, 2022 (i.e., April 11, 2022) or 30 days following publication of the proposing releases in the Federal Register, whichever is longer. As publication in the Federal Register often occurs well after the SEC announces proposed rules on its website, the comment period has the potential to extend further into the Spring; however, the comment period is still relatively short given the extensive nature of the Proposed Rules.

Following the adoption of the Proposed Rules in their final form, the SEC proposes that the rulemaking have an effective date 60 days following the publication of the final rules in the Federal Register (the "Effective Date"), and a compliance date that falls one year after the Effective Date, in order for advisers to transition to compliance with the final rules.

Kirkland is engaging with industry groups as it continues to evaluate the Proposed Rules and monitor related developments. Please contact the Kirkland regulatory attorneys with whom you regularly work if you have questions regarding these proposals.

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1. The Proposing Release is available through this link, and the SEC fact sheet summarizing the Proposed Rules is available through this link. The SEC's February 9 proposals relating to cybersecurity will be covered in a future publication. ↩

2. A "private fund" is an issuer qualifying for the exemption from investment company status under Investment Company Act Section 3(c)(1) — 100-or-fewer beneficial owners — or 3(c)(7) — solely qualified purchaser owners. The Proposed Rules would not appear to apply to pooled investment vehicles relying on exemptions other than 3(c)(1) or 3(c)(7), such as equity or debt real estate funds relying on the exemptions under Section 3(c)(5)(C) or the Investment Company Act's statutory test; clarification from the SEC may be forthcoming.↩

3. Specifically, Advisers Act Section 211(h), which the Proposing Release cites as the basis for the SEC's authority to promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for investment advisers. ↩

4. *See, e.g.*: the July 2019 Commission Interpretation Regarding Standard of Conduct for Investment Advisers; OCIE Risk Alert, Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019); "How We Protect Retail Investors," 2019 Speech by Peter Driscoll, SEC OCIE Director; "Private Equity: A Look Back and a Glimpse Ahead," 2015 speech by Mark Wyatt, SEC OCIE Director; "Spreading Sunshine in Private Equity," 2014 speech by Andrew Bowden, SEC OCIE Director. The SEC's Office of Compliance Inspections and Examinations (OCIE) was renamed the Division of Examinations in December 2020. ↩

5. The Proposing Release contemplates that advisers will be permitted to report on a consolidated basis for certain fund structures (e.g., parallel funds, feeder funds) where consolidated reporting will provide more meaningful information to the private fund's investors and not be misleading. ↩

6. The Proposing Release references the following types of adviser compensation as a non-exhaustive list of examples, including management, advisory, administration and servicing fees and performance-based compensation. ↩

7. The definition of "related person" is intended to be consistent with Form ADV, and would include: all officers, partners or directors (or any person performing similar functions) of the adviser; all persons directly or indirectly controlling or controlled by the adviser; all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and any person under common control with the adviser. The definition generally would pick up advisory affiliates such as fund general partner entities, and in some cases would reach advisers' affiliated operations groups, operating partners or similar affiliated consultants that meet the foregoing prongs of the definition. ↩

8. Not including the adviser compensation amounts disclosed under the previous prong. Any fund expense that also could be characterized as adviser compensation must be shown as adviser compensation in the quarterly statement rather than a fund fee or expense. Under this rubric, back-office or similar services provided by the adviser or its related personnel generally would be disclosed as adviser compensation amounts, even if such services also fall under categories defined as "partnership expenses" in a fund's governing documents. ↩

9. I.e., any entity or issuer in which the private fund has directly or indirectly invested. The Proposing Release notes the SEC's interest in capturing investments other than traditional operating companies, citing that the definition would encompass, for example: loans; credit-related instruments; and other more bespoke assets such as music royalties, aircraft and tanker vessels. ↩

10. The definition of "portfolio investment compensation" would include any compensation, fees and other amounts allocated or paid to the investment adviser or its related persons by the portfolio investment and attributable to the private fund's interest in such portfolio investment. Disclosure of the share of such compensation belonging to co-investors or co-investing funds would be permitted, but optional. The Proposing Release cites to a non-exhaustive list of origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments paid by a portfolio investment. ↩

11. The Proposing Release notes that an adviser should disclose the identity of each covered portfolio investment to the extent necessary for an investor to understand the nature of the conflicts associated with such payments, and provides recommended disclosure practices for scenarios where calculating the ownership percentage may be difficult, such as where a fund does not make equity investments in operating companies, preferred return investments, loans or debt investments. ↩

12. The Proposing Release notes the SEC's expectation that this will be as of the most recent quarter-end, while recognizing that information-gathering challenges may result in the date being a prior quarter-end or other date. The quarterly statement must disclose the date the performance information is current through. ↩

13. The Proposed Rules define an "illiquid fund" as a private fund that: has a limited life; does not continuously raise capital; is not required to redeem interests upon an investor's request; has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; has limited opportunities, if any, for investors to withdraw before termination of the fund; and does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments. ↩

14. As an example of the desired level of specificity, the Proposing Release notes that insurance premiums, administrator expenses and audit fees should all be entered as separate line items with corresponding dollar amounts attributable to such expenses during the reporting period. ↩

15. I.e., as if the investor had contributed capital rather than the fund drawing down on a subscription facility or similar arrangement. The Proposing Release cites as examples subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines or other indebtedness secured by the unfunded capital commitments of the private fund's investors. It also notes the SEC's expectation that interest and other expenses related to the subscription facility would be excluded from these figures, potentially resulting in higher net returns than under historical methodologies. ↩

16. Independence is determined under Rule 2-01(b) and (c) of Regulation S-X, and the audit must be performed in accordance with the requirements of Regulation S-X. The accountant or accounting firm must also be registered with and subject to inspection by the Public Company Accounting Oversight Board. ↩

17. In the Proposing Release, the SEC notes that it considered but rejected some leniency for private funds being liquidated in light of circumstances where the cost of an audit represents a sizeable portion of the fund's remaining assets. ↩

18. In the SEC's view, an "adviser-led secondary transaction" includes any transaction that offers a fund's investors the option to (1) sell all or a portion of their fund interests (which is likely to include tender offer transactions) or (2) convert or exchange all or a portion of their fund interests into interests in another vehicle managed by the adviser or its related persons. ↩

19. The SEC indicated in the Proposing Release its belief that this would typically require disclosure of auditing, consulting, capital raising, investment banking and similar service relationships. ↩

20. Under another recent proposal, the SEC would require advisers to disclose the completion of adviser-led secondary transactions on Form PF within one business day. See the previous *Kirkland AIM* discussing this topic. ↩

21. The reference to private fund investor could have some unanticipated consequences, as described below. ↩

22. The Proposing Release notes that under the SEC's longstanding position that the substantive provisions of the Advisers Act do not apply to non-US clients (including non-US private funds) advised by an offshore SEC-registered adviser, the Proposed Rules on prohibited activities would not apply to such SEC-registered offshore adviser. However, since the Proposed Rules also apply to advisers that are not SEC-registered, which could include offshore advisers to non-US private funds (e.g., exempt reporting advisers), the Proposed Rules appear more onerous to unregistered offshore advisers than to their registered peer firms. ↩

23. However, the Proposed Rules would not cover entities that are excluded from the Advisers Act definition of "investment adviser" such as family offices meeting the requirements of Advisers Act Rule 202(a)(11)(G). See the previous *Kirkland Private Investment & Family Office Insights* discussing this topic. ↩

24. The Proposing Release notes that this must be an offset actually applied, i.e., where the adviser "shifts 100% of the economic benefit of any portfolio investment fee to the private fund investors." As a result, if an adviser received Supplemental Fees in excess of management fees that could be offset, a prorated refund must be made to the private fund, which would be a departure for some funds' governing documents. It is unclear if the SEC contemplates offset arrangements for portfolio investments that involve co-investors or co-investing funds, where a nominal 100% offset is reduced proportionately to account for the fund's share of the portfolio investment. ↩

25. I.e., the July 2019 Commission Interpretation Regarding Standard of Conduct for Investment Advisers. ↩

26. The *pro rata* requirement may pose challenges and distorted allocation of expenses to the extent an adviser's credit fund invests alongside one or more equity funds in a portfolio investment, or later invests in portfolio investments held by equity funds. ↩

27. I.e., a pooled investment vehicle (other than a registered investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) managed by the investment adviser or its related persons, with substantially similar investment policies, objectives, or strategies to those of the private fund. As drafted, the term generally would encompass parallel funds and SMA arrangements.↩

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Related Services

Practices

- Transactional
- Investment Funds

Suggested Reading

- 10 February 2022 Kirkland AIM SEC Proposes Sweeping Rule Changes for Private Fund Advisers (Part 1 of 2)
- 04 February 2022 Kirkland AIM SEC Risk Alert Details Additional Private Fund Adviser Examination Deficiencies
- 31 January 2022 Kirkland AIM SEC Proposes Significant Amendments to Private Fund Manager Reporting on Form PF