

SEC Proposes Significant Changes to Private Fund Adviser Rules

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On February 9, 2022, the Securities and Exchange Commission (SEC) proposed new and amended rules for private fund advisers that may significantly increase the protection of investors in private funds.

The proposed rules would prohibit all private fund advisers from engaging in a variety of activities and would require registered private fund advisers to disclose to their investors on a regular basis certain information regarding their performance, fees, and financial condition.

According to the SEC, its proposed changes to the rules under the Investment Advisers Act of 1940 (Advisers Act) are meant to “protect private fund investors by increasing transparency, competition and efficiency” in their advisers’ management of over \$18 trillion in private fund assets.

What would private fund advisers be prohibited from doing?

The proposed rules would prohibit all private fund advisers from engaging in various common but questionable activities, even with the consent of investors, including:

- charging a portfolio investment for fees for services that the adviser does not provide;
- charging a private fund for regulatory or compliance fees or expenses of the adviser or its related persons;
- charging a private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons;
- charging fees or expenses related to a portfolio investment on a non-pro rata basis;
- seeking reimbursement, indemnification, exculpation, or limitation of the adviser’s liability for the adviser’s breach of fiduciary duty, willful misfeasance, bad faith, recklessness, or negligence;
- borrowing fund assets, or receiving a loan from a private fund client; and
- providing a fund investor redemption rights or information that would have a material negative effect on other investors in the fund or, unless certain disclosures have been and are made to fund investors, any other preferential treatment.

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What are the proposed requirements for registered private fund advisers?

The proposed rules would require registered private fund advisers to take various actions, including:

- providing fund investors with quarterly statements detailing certain standardized measures of fund performance and all fees and expenses paid by the fund, including amounts paid by the fund and by each portfolio investment to the adviser or its related persons;
- having their annual audits performed by an independent public accountant that is registered with, and subject to inspection by, the Public Company Accounting Oversight Board;
- having their annual financial statements prepared in accordance with generally accepted accounting principles and distributed promptly to their investors;
- obtaining a fairness opinion from an independent party on any transactions initiated by the adviser or any of its related persons offering fund investors the choice to sell or exchange any of their interests in the fund; and
- making and keeping records of the adviser's annual compliance review, quarterly statements, financial statement audits, fairness opinions, and preferential treatment disclosures.

Why is the SEC proposing these changes?

- The SEC notes that private funds and their advisers play an increasing role in the economy, with hedge funds engaging in trillions of dollars of financial transactions each month, private equity funds getting involved in mergers and acquisitions, and venture capital funds providing funding to early-stage companies – while some of the largest groups of private fund investors include pension plans, college endowments, and nonprofit organizations.
- After a decade of overseeing most private fund advisers, the SEC said it found practices persist that have caused overpayment of fees and expenses to private fund advisers and lack of disclosure of conflicts of interest to private fund investors. The SEC says that private fund advisers "frequently do not provide investors with sufficiently detailed information about private fund investments." For example, advisers often do not disclose the magnitude and scope of fees and expenses charged, and frequently present fund performance based on different assumptions.
- "Without sufficiently clear, comparable information, even sophisticated investors would be unable to protect their interests or make sound investment decisions," the SEC writes. The SEC also says it has continued to see advisers reaping substantial financial benefits through the abuse of undisclosed conflicts of interest relating to compensation and other transactions.
- The SEC says it is proposing rules that would prohibit all private fund advisers from engaging in certain "sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors." The SEC also says it seeks to require registered investment advisers to private funds to "provide transparency to their investors regarding the full cost of investing in private funds and the performance of such private funds."

What's next?

- There is a public comment period open until April 11, 2022, or 30 days after the proposed rule is published in the Federal Register, whichever is later.
- If adopted, the proposed rules would take effect in one year's time.