Baker McKenzie.

Client Alert

March 2022

United States: the SEC's Private Fund Adviser Proposal Contemplates Major Changes for Private Investment Vehicles

In brief

A significant new rulemaking proposal[1] from the U.S. Securities and Exchange Commission ("SEC") would fundamentally alter how private investment funds[2] negotiate and communicate with their investors. The proposal (the "Proposal") would prohibit indemnification of managers for many types of mistakes, restrict some common side letter terms, require auditors to report certain events to the SEC and mandate quarterly reporting for private fund investors. Crucially, some of the Proposal's prohibitions would, for the first time, substantively regulate unregistered and exempt investment advisers, both inside and outside of the United States. The repercussions of the Proposal would extend beyond private fund managers and affect co-investment structures, portfolio companies, institutional investors, and many key service providers to private funds. Auditors, in particular, may come under greater SEC enforcement scrutiny.

The Proposal is not yet final, and the SEC is requesting comments, which will be due no earlier than April 11, 2022. Interested parties are encouraged to reach out to the Baker McKenzie attorneys with whom they typically work to discuss any possible comments, questions or concerns.

Summary

This alert summarizes the key features of the Proposal and indicates which types of advisers are in-scope: investment advisers registered under the Investment Advisers Act of 1940 (the **"Advisers Act"**), other exempt investment advisers and non-U.S. investment advisers.

Proposed Requirement	U.S. Advisers In-Scope?	Non-U.S. Advisers In-Scope?
Prohibited Activities: Significant Changes to Indemnification An adviser would be prohibited from seeking reimbursement, indemnification, exculpation, or limitation of its liability by a private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or	All U.S. private fund advisers, regardless of whether they are registered with the SEC, the U.S. states, or exempt from registration (e.g., exempt reporting advisers) or prohibited from registration.	Any non-U.S. private fund adviser with a U.S.-domiciled fund. This would include exempt "foreign private advisers" and exempt reporting advisers. Note that other clients and non-U.S. funds of a non-U.S. adviser

[1] "Private Fund Advisers, Documentation of Registered Investment Adviser Compliance Reviews", SEC Release Nos. IA-5955; File No. S7-03-22 (pending publication in the Federal Register) available at https://www.sec.gov/rules/proposed/2022/ia-5950.pdf

[2] The SEC uses the term private fund to refer to privately offered investment vehicles that must use one of two common exemptions from registration under the U.S. Investment Company Act of 1940: Section 3(c)(1) and Section 3(c)(7). While these exemptions are most often used by private equity, hedge and venture capital funds, the exemptions are also used by other private collective investment vehicles that invest in securities. Some (but not all) real estate, infrastructure, and real asset funds will be subject to the proposed rules to the extent they rely on these exemptions.

recklessness in providing services to the private fund. While the SEC staff have long cautioned against fund provisions that purport to waive liability under the securities laws, [3] the Proposal's broad prohibition on indemnification for negligence or any breach of fiduciary duty is a departure from past cautioning and will come as a surprise to many market participants. We expect significant industry discussion and comment on this portion of the Proposal.		may also be indirectly affected by aspects of the proposal (e.g., a U.S. requirement to allocate co-investment expenses pro rata to a U.S. fund would result in non-U.S. co-investors paying higher expenses; any changes to U.S. fund expenses may drive corresponding changes for non-U.S. clients).
Prohibited Activities: Changes to Co-investment Structures Advisers would be required to charge fees and expenses related to portfolio investments on a pro rata basis whenever multiple clients of an adviser or its related persons are investing. This aspect of the Proposal would significantly affect common co-investment terms; for example, co-investment arrangements would need a mechanism to charge broken deal expenses to all co-investors.		
Prohibited Activities: Prohibitions on Charging Certain Regulatory Expenses to Private Funds Private funds would no longer be permitted to pay for various regulatory and compliance expenses (including expenses associated with filings, investigations and examinations) that the SEC deems to be adviser expenses. This is contrast to current practice where such these expenses have been permissible when they have previously and clearly disclosed to investors. This outright prohibition represents a further shift away from the concept that providing appropriate disclosure is sufficient when dealing with private fund investors.		
Prohibited Activities: Prohibitions on Charging Other Types of Fees to Private Funds The Proposal would also prohibit an adviser from charging other fees for portfolio company services (e.g., accelerated monitoring fees) that the adviser does not perform or reasonably expect to perform.		

[3] See, e.g., "Commission Interpretation Regarding Standard of Conduct for Investment Advisers", SEC Release No. IA-5248; File No. S7-07-18, (June 5, 2019) available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

© 2022 Baker & McKenzie

Prohibited Activities: Loans from Funds to Advisers The Proposal would prohibit an adviser from borrowing money, securities, or fund assets, or receiving credit from a private fund client. The Proposal should not affect loans from an investment adviser to a fund or loans to and from third parties with a fund.		
Prohibited Activities: Reducing Adviser Clawback Liabilities for Taxes Some funds "claw back" (i.e., require investment advisers to re-pay) previously distributed performance compensation under certain circumstances. Fund documents often reduce this clawback liability by a hypothetical amount of taxes that adviser personnel had to pay after receiving such carried interest distributions. Under the Proposal, this common practice would be prohibited.[4]		
Proposed Requirement	**U.S. Advisers In-Scope?**	**Non-U.S. Advisers In-Scope?**
Preferential Treatment: Prohibition on Preferential Liquidity and Transparency Under certain circumstances, advisers would be prohibited from providing an investor with better rights than other investors. In particular, an adviser would not be allowed to grant preferential liquidity or information rights to investors in a private fund or any substantially similar pool of assets if the adviser **"reasonably expects"** these rights to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.[5]	Yes. All U.S. private fund advisers, regardless of whether they are registered with the SEC, the U.S. states, or exempt from registration (e.g., exempt reporting advisers) or prohibited from registration.	Yes. Any non-U.S. private fund adviser with a U.S.-domiciled fund. This would include exempt "foreign private advisers" and exempt reporting advisers. The limitations on preferential treatment would indirectly affect the terms offered to non-U.S. clients.
Preferential Treatment: Mandatory Disclosure of Other Preferential Treatment Other common types of side letter terms (e.g., fee discounts, excuse rights) would not be prohibited but would need to be disclosed to other investors. The current market practice in the United States (to describe generally the types of preferential rights that may be granted to investors) would not be sufficient; the		

[4] The proposal is not limited to hypothetical amounts of taxes; instead, any reduction of clawback liability for actual, potential or hypothetical adviser/adviser personnel taxes would be prohibited.

[5] As a result, an adviser could not provide preferential liquidity or information rights to a fund-of-one or separately managed account with a similar investment strategy.

Baker McKenzie.

Proposal instead requires specific details (e.g., the amounts of fee discounts). These disclosures would be made to new investors and thereafter annually to existing investors.		
Quarterly Disclosure Requirements: Fund-Level Fee and Expense Disclosures The Proposal would create a mandatory quarterly report that would provide fund-level fee and expense information, including: 1) a detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the fund during the reporting period (**"Adviser Compensation"**); 2) a detailed accounting of all fees and expenses paid by the fund during the reporting period other than the Adviser Compensation (i.e., fund expenses); 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. The reporting requirement reflects the SEC's concerns with the current market practice of disclosing a "laundry list" of expenses that might be covered by funds without providing context for which expenses are material.	Only SEC-registered investment advisers with private funds	Non-U.S. SEC-registered investment advisers with U.S.-domiciled funds[6]
Quarterly Disclosure Requirements: Portfolio-Level Fee and Expense Disclosures An adviser would be required to provide a table including the following information with respect to any covered "portfolio investment":[7]		

[6] Under a long-standing no-action letter, the SEC staff has taken the position that a non-U.S. adviser may treat a private fund organized and incorporated in a country other than the United States as its client for all purposes under the Act other than Sections 203, 204, 206(1) and (2) of the Advisers Act. Because this portion of the Proposal is adopted under other sections of the Advisers Act, it should not apply offshore to offshore funds. American Bar Association, SEC No-Action Letter (August 10, 2006), available at CPY Document Title (sec.gov).

[7] The term "portfolio investment," as proposed, means any entity or issuer in which the fund has invested directly or indirectly (e.g., holding companies, subsidiaries, acquisition vehicles, special purpose vehicles), which the Staff notes is intended to have a broader scope than the term "portfolio company." The expanded definitional scope covers investments other than traditional operating companies, including loan origination, credit-related instruments or more bespoke asset investments (e.g., music royalties, aircraft). As it is relatively common (especially for private equity and venture capital funds) to structure investments through multiple layers of investment entities, the adviser would have the responsibility to determine, in good faith, which entity constitutes the portfolio investment.

Baker McKenzie.

1) a detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period; and 2) the fund's ownership percentage[8] in each covered portfolio investment as of the end of the reporting period. Consistent with the approach for fund-level disclosure, an adviser would be required to provide a line-item breakdown of all portfolio investment compensation allocated or paid with respect to a covered portfolio investment both before and after the application of any offsets, rebates, or waivers.		
Quarterly Disclosure Requirements: Performance Information Disclosure Through the Proposal, the SEC further expressed concern that fund performance reporting is often complex, not standardized, or simply not provided. To the address this issue, the Proposal would require the quarterly statement to disclose performance information using standardized performance metrics; the specifics of which will depend upon whether the fund is categorized as an "illiquid fund"[9] or a "liquid fund."[10] While the application of these categories will typically be straightforward for traditional investment products *(e.g.*, private equity and venture capital funds as illiquid funds and hedge funds as liquid funds), the SEC recognized that a variety of products may not fit perfectly into the two categories and these funds (*e.g.*, hybrid funds) will need to be categorized based on the facts and circumstances.[11]		

[8] If the fund does not have an ownership interest in the covered portfolio investment, the adviser would be required to list zero percent as the fund's ownership percentage along with a brief description of the fund's investment in such covered portfolio investment.

[9] The term **"illiquid fund"**, as proposed, means a "fund that: (i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interest upon an investor's request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before the termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of investment strategy market-traded securities and derivative instruments."

[10] The term **"liquid fund"** means any fund that does not fall under the definition of illiquid fund.

[11] The performance disclosure requirements in the Proposal should be considered in the context of the SEC's recent revisions to the marketing rule for registered investment advisers generally (the final compliance date for the marketing rule is November 5, 2022); while the marketing rule and the Proposal share many similarities, there are not entirely consistent. For more information, see Baker McKenzie Client Alert, SEC Adopts New Framework for Investment Adviser Marketing (Dec. 28, 2020) available at https://insightplus.bakermckenzie.com/bm/financial-institutions_1/united-states-sec-adopts-new-framework-for-investment-adviser-marketing.

© 2022 Baker & McKenzie

Liquid Funds: quarterly statements would need to provide fund performance information for: 1) annual net total returns for each calendar year since inception; 2) average annual net total returns over the one-, five-, and ten- calendar year periods; and 3) cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement. Illiquid Funds: quarterly statements would need to include: 1) the gross internal rate of return and gross multiple of invested capital for the fund; 2) net internal rate of return and net multiple of invested capital for the fund; and 3) gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the fund's portfolio, with the realized and unrealized performance shown separately. In addition to the above performance information, the adviser would be required to provide investors with a statement of contributions and distributions for the fund. The Proposal specifically excludes fund-level subscription facilities from the above performance metrics because the SEC believes such arrangements artificially inflate performance data.		
Adviser-Led Secondaries: Mandatory Fairness Opinions The Proposal would require that registered investment advisers obtain a fairness opinion in connection with any "adviser-led" secondary transaction.[12] The entity issuing the fairness opinion must be an "independent opinion provider" (i.e., an entity that provides fairness opinions in the ordinary course of business and is not a related person of the adviser). But, in	Only SEC-registered investment advisers with private funds	Non-U.S. SEC-registered investment advisers with U.S.-domiciled funds

[12] An "adviser-led" (more commonly referred to as "GP-led") secondary is any transaction in which an adviser creates an offer to buy or exchange fund interests from investors (other than through the standard liquidity terms of the fund). An adviser-led secondary is not limited to situations where the adviser itself buys the fund interests (e.g., an adviser-led secondary, for these purposes, could include situations where the adviser arranges for a third party to purchase fund interests). For additional details about the legal considerations associated with adviser-led secondaries, see the Baker McKenzie guide, Unlocking Paths to Capital: The GP-Led Liquidity Solutions Guide (April 27, 2021) available at https://www.bakermckenzie.com/en/insight/publications/guides/liquidity-solutions-guide

© 2022 Baker & McKenzie

an echo from other SEC valuation reforms,[13] the adviser would need to disclose to investors any material relationships that it and its related persons have had with the opinion provider over the past two years.		
Audits for Private Funds: Mandatory Audit Advisers that directly or indirectly provide advice to private funds must cause the funds to undergo a financial statement audit prepared under GAAP at least annually and upon liquidation.[14] Non-U.S. private funds[15] would be permitted to use other audit standards but would be required to provide a reconciliation of material differences from GAAP. The auditor must meet the independence standards in Rule 2-01(b) and (c) of Regulation S-X and be registered and subject to regular inspection by the PCOAB.[16] If a subadviser (or any SEC-registered advisory entity) does not control a private fund and therefore cannot directly mandate that the fund be audited, the Proposal would prohibit the subadviser from providing investment advice to the fund unless it takes "all reasonable steps to cause the private fund to undergo a financial statement audit".	Only SEC-registered investment advisers with private funds. GAAP reconciliation is permitted for non-U.S. funds; note that this could include U.S.-registered sub-advisers to a private fund.	Non-U.S. SEC-registered investment advisers with U.S.-domiciled funds. GAAP reconciliation is permitted.
Audits for Private Funds - Auditor Notifications to the SEC The Proposal also requires auditors to notify the SEC electronically if the audit firm issues an audit report to a private fund that contains a		

[13] Note, for example, the long-standing SEC concern about that conflicts of interests that arise when independent valuation providers have an interest in providing other services to advisers and their funds. "Good Faith Determinations of Fair Value", SEC Release IC-34128 available at https://www.sec.gov/rules/final/2020/ic-34128.pdf. For a broader discussion of the SEC's enforcement activity with respect to valuations under both the Advisers Act and the investment Company Act, see Karl Egbert, "Valuation and Punishment: How the SEC's Fair Value Proposal Might Affect Future Valuation Enforcement", The Investment Lawyer (Dec. 2020).

[14] The mandatory audit requirements in the Proposal run parallel to the audit approach to compliance in Advisers Act Rule 206(4)-2 (i.e., the custody rule). , Custody rule compliance can be arduous due to the custody rule's complexity and the custody rule's audit approach can be costly for funds with very limited activity (e.g., in their liquidation period), limited assets, or a limited set of investors. The SEC staff now has an opportunity to provide badly needed reforms to the custody rule and harmonize it with the Proposal.

[15] The Proposal defines "foreign private funds" as those either organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States. Note that this definition of "foreign" is more expansive than the concept used elsewhere in the Proposal and under the Advisers Act generally, which largely focuses on domicile.

[16] As a result of this threshold requirement, audits therefore could not be provided from offices in jurisdictions that have been designated as problematic under the U.S. Holding Foreign Companies Accountable Act and new PCAOB Rule 6100. While no countries have yet been designated under this rule, it is understood to be focused on access to books and records in China. For further discussion, see Baker McKenzie Client Alert," SEC takes first step towards implementing the Holding Foreign Companies Accountable Act" (March 30, 2021) available at North America: SEC takes first step towards implementing the Holding Foreign Companies Accountable Act - Baker McKenzie InsightPlus.

© 2022 Baker & McKenzie

modified opinion or if the audit firm resigns, does not allow itself to be considered for reappointment, or is dismissed or terminated as fund auditor.[17] This notification requirement would cement auditors' status as a gatekeeper for private fund integrity. This status, in turn, would likely increase auditors' scrutiny of private funds.		
Written Compliance Reviews SEC-registered investment advisers are required to conduct an annual review of their compliance procedures pursuant to Rule 206(4)-7 under the Advisers Act. However, the SEC noted that some advisers do not document this process or retain records of it. The Proposal would mandate a written record of the compliance review and require that advisers maintain such records for at least five years. In the Proposal, the SEC also expressed concern that some advisers were claiming attorney-client privilege with respect to materials related to their annual compliance reviews. The Proposal's mandate of a stand-alone record, essentially a results document, that would not include or contemplate legal advice, should assist the SEC Division of Examinations staff in evaluating compliance reviews.	All SEC-registered advisers (whether or not they manage private funds)	All SEC-registered advisers with U.S. clients (whether or not they manage private funds)

[17] These notifications will need to examined in light of data security and data transfer laws outside of the United States.

© 2022 Baker & McKenzie

Broader Impact and Next Steps

To some extent, the Proposal represents an extension of long-standing concerns of the SEC staff.[18] Where the Proposal provides guidance that the SEC staff previously issued primarily via examinations and enforcement actions, it represents a constructive step towards regulatory clarity. However, other portions of the Proposal are surprising, and raise fundamental questions about whether basic and long-standing features of the private funds industry (like performance allocations/carried interest) are now considered as somehow against public policy.[19] Still other portions of the Proposal, such as the SEC's discussion of fiduciary duties, deserve a deeper and broader conversation about who and what should be a fiduciary. The private funds industry will need to consider carefully which portions of the Proposal represent positive steps to reduce bad actors and which portions represent significant burdens without commensurate benefits. Please reach out to the Baker McKenzie lawyers with whom you regularly work if you have any questions or concerns about the Proposal ahead of the April deadline for public comments.

This client alert was authored by Karl Egbert, Kennan Castel-Fodor, Zlatomira Simeonova, Amy Greer, Peter Chan, Kristin Rice-Gonzalez and Valerie Mirko.

---

[18] For example, see the 2020 risk alert from the SEC Office of Compliance Inspections and Examinations, "Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf.

[19] *See e.g.*, the discussion of performance compensation as a "disproportionate share of profits" because it does not match an adviser's ownership percentage of the fund. The Proposal at 144.

© 2022 Baker & McKenzie

Contact Us

Karl Egbert
Partner, NY
karl.egbert@bakermckenzie.com

Amy Greer
Partner, DC / NY
amy.greer@bakermckenzie.com

Valerie Mirko
Partner, DC
valerie.mirko@bakermckenzie.com

Kristin Rice-Gonzalez
Partner, Chicago
kristin.rice-gonzalez@bakermckenzie.com

Peter Chan
Partner, Chicago / DC
peter.chan@bakermckenzie.com

Kennan Castel-Fodor
Registered Foreign Lawyer, London
kennan.castel-fodor@bakermckenzie.com

Zlatomira Simeonova
Associate, DC
zlatomira.simeonova@bakermckenzie.com

© 2022 Baker & McKenzie. **Ownership:** This site (Site) is a proprietary resource owned exclusively by Baker McKenzie (meaning Baker & McKenzie International and its member firms, including Baker & McKenzie LLP). Use of this site does not of itself create a contractual relationship, nor any attorney/client relationship, between Baker McKenzie and any person. **Non-reliance and exclusion:** All information on this Site is of general comment and for informational purposes only and may not reflect the most current legal and regulatory developments. All summaries of the laws, regulation and practice are subject to change. The information on this Site is not offered as legal or any other advice on any particular matter, whether it be legal, procedural or otherwise. It is not intended to be a substitute for reference to (and compliance with) the detailed provisions of applicable laws, rules, regulations or forms. Legal advice should always be sought before taking any action or refraining from taking any action based on any information provided in this Site. Baker McKenzie, the editors and the contributing authors do not guarantee the accuracy of the contents and expressly disclaim any and all liability to any person in respect of the consequences of anything done or permitted to be done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents of this Site. **Attorney Advertising:** This Site may qualify as "Attorney Advertising" requiring notice in some jurisdictions. To the extent that this Site may qualify as Attorney Advertising, PRIOR RESULTS DO NOT GUARANTEE A SIMILAR OUTCOME. All rights reserved. The content of the this Site is protected under international copyright conventions. Reproduction of the content of this Site without express written authorization is strictly prohibited.