

SEC Proposes Radical Changes to Practices for Private Funds

February 11, 2022

On February 9, by a vote of three to one, the Securities and Exchange Commission (SEC) proposed five sweeping new rules governing private funds. The comment period on the proposal expires 60 days from February 9 or 30 days from publication in the *Federal Register*, whichever is sooner.

Some of the proposals would apply only to advisers who are registered or required to be registered; other proposals would apply to all advisers, even those exempt from registration.

1. Quarterly statement requirement.

Advisers who are registered, or required to be registered, would be required to provide investors in the private funds they manage with certain information. This obligation would be triggered after six months of fund operation and would require the statements to be delivered within 45 days of the end of each quarter. Delivery would have to be made to the investors in the private fund, not merely to the private fund itself. The required quarterly information includes (all italicized terms are defined in the proposed rule, available at Advisers Act Rel. 5955):

A. A so-called “Fund Table,” setting forth the following information:

1. “A detailed accounting of all compensation, fees, and other amounts allocated or paid to the investment adviser or any of its *related persons* by the fund during the *reporting period*, with separate line items for each category of allocation or payment reflecting the total dollar amount, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and *performance-based compensation*.”
2. “A detailed accounting of all fees and expenses paid by the private fund during the *reporting period* . . . , with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses.”
3. “The amount of any offsets or rebates carried forward during the *reporting period* to subsequent periods to reduce future payments or allocations to the adviser or its *related persons*.”

B. A so-called “Fund Investment Table,” setting forth the following information:

1. “A detailed accounting of all *portfolio investment compensation* allocated or paid to the investment adviser or any of its *related persons* by the *covered portfolio investment* during the *reporting period*, with separate line items for each category of allocation or payment reflecting the total dollar amount, presented both before and after the application of any offsets, rebates, or waivers.”

2. “The fund’s ownership percentage of each such *covered portfolio investment* as of the end of the *reporting period*, or zero, if the fund does not have an ownership interest in the *covered portfolio investment*, along with a brief description of the fund’s investment.”
3. “[P]rominent disclosure regarding the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated and include cross references to the sections of the private fund’s organizational and offering documents that set forth the applicable calculation methodology.”

C. Performance information:

Different performance information would be required depending on whether the fund is liquid or illiquid. An illiquid fund is defined as one which: “(i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor’s request; (iv) has 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 termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments.” Any fund that does not meet the definition of an illiquid fund is a liquid fund.

Funds must present consolidated information for all substantially similar funds “to the extent doing so would provide more meaningful information to the private fund’s investors and would not be misleading.” Funds also must disclose “the criteria used and assumptions made in calculating the performance.”

1. A liquid fund must report quarterly the following information:
 - a. “Annual net total returns for each calendar year since inception;”
 - b. “Average annual net total returns over the one-, five-, and ten- calendar year periods;” and
 - c. “The cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.”
2. An illiquid fund must report quarterly the following information:
 - a. Complex information about rate of return and adjusted investment capital.

2. Delivery of audited financial statements.

All private funds managed by an adviser that is registered or required to be registered would be required to have an audit conducted by a firm that is independent and a member of the PCAOB. For US based funds, the audit must comply with GAAP requirements; foreign based funds must comply with substantially similar requirements. The audited financial statements must be delivered “promptly” upon completion to investors in the fund. The auditor would be required to notify the SEC if it issues a qualified opinion or resigns or is fired.

3. Prohibited practices for all advisers to private funds, even if exempt from registration include:

- A. Charging for services not provided: “Charge a *portfolio investment* for monitoring, servicing, consulting, or other fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment;”

- B. Charging for defense of inspection or investigation: “Charge the private fund for fees or expenses associated with an examination or investigation of the adviser or its *related persons* by any governmental or regulatory authority;”
- C. Charging for compliance expenses: “Charge the private fund for any regulatory or compliance fees or expenses of the adviser or its *related persons*;”
- D. Reducing clawbacks: “Reduce the amount of any *adviser clawback* by actual, potential, or hypothetical taxes applicable to the adviser, its *related persons*, or their respective owners or interest holders;”
- E. Hedge clauses: “Seek 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;”
- F. Charging or allocating other than on a pro rata basis: “Charge or allocate fees and expenses related to a *portfolio investment* (or potential *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*;”
- G. Borrowing from fund: “Borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client.”
- H. Preferential redemption rights (subject to note below): “Grant an investor in the private fund or in a *substantially similar pool of assets* the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a *substantially similar pool of assets*;”
- I. Preferential disclosure of information (subject to note below): “Provide information regarding the portfolio holdings or exposures of the private fund, or of a *substantially similar pool of assets*, to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a *substantially similar pool of assets*.”

NOTE: Preferential treatment is permitted if the adviser does not believe such treatment will have a material negative effect on investors in the private fund or in substantially similar pools of assets, provided the preferential treatment is disclosed in advance and in writing to all investors in the relevant private funds and these investors also receive annual written reminders of the preferential treatment.

- 4. For transactions that permit investors in a private fund managed by an adviser that is registered or required to be registered to sell or convert their interests to the adviser or a related person of the adviser, an independent fairness opinion would have to be delivered as well as a summary of the terms of the proposed transaction.
- 5. The annual compliance review all registered advisers must complete will now have to be in writing, with the writing retained and subject to SEC inspection.

CONTACTS

For more information, please contact any of the following members of Katten's [Financial Markets and Funds](#) practices.



Lance A. Zinman
+1.312.902.5212
lance.zinman@katten.com



Allison C. Yacker
+1.212.940.6328
allison.yacker@katten.com



Wendy E. Cohen
+1.212.940.3846
wendy.cohen@katten.com



Richard D. Marshall
+1.212.940.8765
richard.marshall@katten.com



Mark D. Goldstein
+1.212.940.8507
mark.goldstein@katten.com



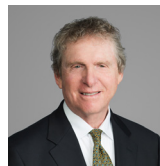
Christian B. Hennion
+1.312.902.5521
christian.hennion@katten.com



David Y. Dickstein
+1.212.940.8506
david.dickstein@katten.com



Henry Bregstein
+1.212.940.6615
henry.bregstein@katten.com



Fred M. Santo
+1.212.940.8720
fred.santo@katten.com

Katten

katten.com

CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SHANGHAI | WASHINGTON, DC

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