

## What to Worry About With the SEC's Move to Regulate Private Funds

March 24, 2022

The Securities and Exchange Commission (SEC) has been very busy these last few weeks as evidenced by a series of rule proposals released as part of what looks like an ambitious agenda for 2022. This includes tackling areas such as [cybersecurity](#), [risk management](#), [more reporting under Form PF](#), [environmental, social and governance \(ESG\) disclosures](#), proposed amendments to the beneficial ownership regime and new reporting under short sale rules.

The SEC also signaled [a major shift for the Investment Advisers Act of 1940](#), which could affect the day-to-day business of almost all private fund advisers, as well as all other advisers (even those that are exempt from registration). The proposed rules include:

- specific requirements for providing investors with detailed quarterly reports;
- obtaining annual audited financial statements for each for each private fund;
- providing specific disclosures to investors and potential investors of all preferential terms granted to any investor;
- prohibitions on a number of activities; and
- other requirements and solicitation of comments on a number of matters that could significantly affect private fund advisers, including whether certain common private fund fee and expense arrangements should be prohibited (e.g., the standard “2 and 20” compensation arrangements).

In a webinar titled “SEC’s Proposals on Private Funds – What to Worry About,” Katten’s Investment Management and Funds team broke down the following: What do you need to know? What should you worry about it? And how can you prepare? Here are those key points.

### Prohibited Practices

**The change:** The new rules would prohibit all advisers to private funds, even if exempt from registration, from engaging in a number of practices. These include:

- charging for services not provided;
- charging for defense of inspection or investigation and compliance expenses of the private fund adviser;
- reducing clawbacks by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders;
- using hedge clauses, i.e., seeking reimbursement, indemnification, exculpation, or limitation of liability for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund;

- allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis;
- borrowing from fund or receiving a loan or an extension of credit, from a private fund client; and
- providing preferential treatment related to redemption rights and access to portfolio information.

**How to prepare:** Operational timing could be everything when it comes to this change, and when bringing on multiple investors, advisers will want to consider timing of this process to satisfy the rule. Facts and circumstances will also matter a great deal here, so you should discuss how and what to disclose with the person preparing your disclosures.

## Quarterly Statements

**The change:** Registered investment advisers would be required to provide private fund investors with detailed quarterly statements that include standardized disclosures on fees and expense (both at the fund level and at the portfolio investment level) and investment performance. Different performance information would be required depending on whether the fund is liquid or illiquid. Statements would need to be distributed to investors within 45 days after each calendar quarter end.

**What to worry about:** This would impact funds with at least two full calendar quarters of operating results, and the statements must be sent to all fund investors, including investors in investing pools.

**How to prepare:** Improve recordkeeping systems and create and retain analysis and determination for each of your funds.

## Audits

**The change:** All private funds managed by an adviser that are 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 Public Company Accounting Oversight Board (PCAOB). 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.

**What to worry about:** This is similar what most firms are already doing, but this rule makes that mandatory. And the flexibility around timing and participation that exists under the custody rule would not exist under this requirement.

**How to prepare:** These audits must be performed by an independent public accountant in accordance with US accounting standard and presented in accordance with the US Generally Accepted Accounting Principles (GAAP). As proposed, the rule doesn’t apply to exempt reporting advisers, like private funds advisers and venture capital funds advisers.

## Secondary Transactions

**The change:** Secondary transactions, i.e., generally sales of interests in private funds or exchanges of such interests for interests in other adviser-managed funds, that are viewed as initiated by the adviser — “adviser led” — would be subject to a “fairness opinion.”

**What to worry about:** Traditionally, advisers would disclose to investors any potential conflict of interest in an adviser-led secondary transaction. Now a fairness opinion would be required, but there’s a lack of clarity about how “adviser led” is defined or consideration for the expense of, and the amount of time needed to deliver, a fairness opinion.

**How to prepare:** As with many of these changes, begin to think about the operational and expense burden these would present and what disclosure requirements and prohibited activity requirements would mean in the context of your own business.

[Watch the video of the program.](#)

## Additional Katten Resources

[“Client Alert: Proposed SEC Rules for Investment Advisers and Regulated Funds, and New FTC Safeguard Rule Applicable to Private Funds,”](#) March 3, 2022

[“SEC Staff Observes Practices of Private Fund Advisers That Raise Concerns,”](#) February 11, 2022

[“SEC Proposes Radical Changes to Practices for Private Funds,”](#) February 11, 2022

[“ESG Remains a Priority: SEC Asset Management Advisory Committee Adopts ESG Disclosure Recommendations,”](#) July 22, 2021

[“Businesses Must Prepare For Expansive AML Reporting of Beneficial Ownership Interests,”](#) April 29, 2021

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## CONTACTS

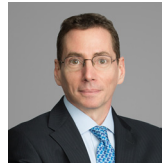
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