Lowenstein Sandler

Investment Management

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SEC Proposes New Rules and Amended Form PF Requirements for Private Fund Managers; Amended Annual Review Requirements and New Cybersecurity Rule for SEC-Registered Investment Advisers

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What You Need To Know:

- **The SEC has proposed new rules applicable to private fund managers, some of which apply broadly to private fund managers that are not registered with the agency.**
- **The SEC has proposed to substantially expand Form PF reporting requirements.**
- **The SEC has proposed an amendment to the existing Compliance Rule applicable to SEC-registered investment advisers, requiring advisers to document their annual reviews in writing.**
- **The SEC has proposed new rules related to cybersecurity risk management applicable to SEC-registered investment advisers and registered investment companies.**
- **The public will have time to submit comments on the proposed rules and changes to existing rules.**

In three separate releases issued between January 2022 and February 2022 (each a **Release** and collectively, **Releases**), the U.S. Securities and Exchange Commission (**SEC**) proposed a series of new and amended rules under the Investment Advisers Act of 1940, as amended (**Advisers Act**), and the Investment Company Act of 1940, as amended (**Company Act**). The Releases include new and amended rules of significant import to managers of private funds (**Private Fund Managers**). Certain of the new rules would apply only to Private Fund Managers that are also SEC-registered investment advisers (**SEC-Private Fund Managers**). Others would apply to Private Fund Managers generally, irrespective of whether they are registered with the SEC or one or more states, are exempt reporting advisers, or are prohibited from registration. The Releases also include proposed changes applicable to all SEC-registered investment advisers, including such advisers that are not Private Fund Managers. This Client Alert summarizes the newly proposed rules and changes to existing rules (collectively, **Proposed Rules**) and provides a high-level summary of their potential implications.

I. New Rules for Private Fund Managers

In a Release issued on Feb. 9, 2022, the SEC set forth a number of Proposed Rules imposing new requirements on Private Fund Managers as described below. Among other things, the proposed requirements are designed to provide investors with greater transparency and more detailed information with respect to the full cost of investing in private funds and the total compensation paid to Private Fund Managers, and to address certain conflicts of interests between Private Fund Managers and their investors that the SEC has identified as particularly acute.

a. Quarterly Statement Rule

Proposed Rule 211(h)(1)-2 would, if adopted, require SEC-Private Fund Managers to distribute a quarterly statement to the underlying investors in each private fund they manage within 45 days of the relevant quarter end. The statement would contain a detailed accounting of all fees (e.g., management, sub-advisory, performance-based compensation, and similar fees or payments) and expenses (e.g., organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses) paid by the private fund to the manager during the relevant period. The statement would include information regarding compensation or other amounts paid by the private fund's portfolio investments/companies to the SEC-Private Fund Manager or any of its related persons. Finally, the statement would disclose certain information regarding the performance of the private fund, including:

- For illiquid funds,[1] the gross and net internal rate of return, and gross and net multiple of invested capital for the illiquid fund, to capture performance from its inception through the end of the current calendar quarter, with the realized and unrealized portions of the illiquid fund's portfolio performance shown separately
- For liquid funds,[2] the annual net total returns from inception, average annual net total returns over specified time periods (e.g., one, five, and 10 years), and quarterly net total returns for the current calendar year

The rule would require consolidated reporting for substantially similar pools of assets to the extent that doing so would provide more meaningful information to investors and would not be misleading.

b. Mandatory SEC-Private Fund Manager Audits Rule

Proposed Rule 206(4)-10 would require SEC-Private Fund Managers to cause the private funds they advise to undertake a financial statement audit at least annually and upon liquidation.[3] The proposed rule would require that (i) the audit be conducted by an independent public accountant registered with, and subject to, the regular inspection of the PCAOB in accordance with U.S. GAAP, and (ii) the audited financial statements be prepared in accordance with U.S. GAAP. As proposed, Rule 206(4)-10 would also require SEC-Private Fund Managers to distribute the audited financial statements required under the rule to fund investors "promptly" after the completion of the audit.[4] Finally, the proposed rule requires a written agreement between the SEC-Private Fund Manager (or each private fund they manage) and the auditor pursuant to which the auditor is required to notify the SEC upon the auditor's termination, or upon the issuance of a modified (or qualified) opinion.

c. Adviser-Led Secondaries Rule

Proposed Rule 211(h)(2)-2 would require SEC-Private Fund Managers to obtain a fairness opinion in connection with a secondary transaction which they propose to lead. In secondary transactions, existing investors are offered the option to sell or exchange their interests in the private fund for interests in another vehicle advised by the manager. If adopted, the rule would require an independent opinion provider to opine on the fairness of the price being offered to the private fund for any assets being sold as part of the transaction. The new rule would also require SEC-Private Fund Managers to prepare and distribute to investors a summary of any material business relationships between the independent opinion provider and the manager within the past two years in order to enable investors to assess any potential conflicts of interest associated with the procurement of the opinion.

d. Prohibited Activities Rule

Proposed Rule 211(h)(2)-1 sets forth a list of activities and practices by Private Fund Managers which the SEC believes are contrary to the public interest and to the protection of investors. Under this rule, Private Fund Managers would be prohibited from engaging,

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[1] An "illiquid fund" is defined as a private fund that (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 as a predominant operating strategy to return 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. Most private equity, real estate, and venture capital funds would likely fall into this definition.

[2] A "liquid fund" is defined as any private fund that is not an illiquid fund. Most hedge funds would likely fall into this definition.

[3] The proposed SEC-Private Fund Manager mandatory audit rule sets forth similar or identical requirements to the existing "Custody Rule," Rule 206(4)-2, which would remain in place. SEC-Private Fund Managers would not be able to rely on a surprise examination (among other things) conducted pursuant to the Custody Rule to comply with the new rule; they must obtain an audit.

[4] While there is currently no guidance as to the specific meaning of "promptly" and the timing required under the proposed rule, many SEC-Private Fund Managers already undertake annual audits by independent accountants registered with the PCAOB with respect to their managed private funds, and distribute the audited financial statements to underlying investors within 120 days after the fund's fiscal year-end in accordance with the Custody Rule.

directly or indirectly, in the following activities and practices:

- Charging fees and expenses to a private fund or its portfolio investments/companies for unperformed services (e.g., accelerated monitoring fees) and fees associated with an examination or investigation of such Private Fund Managers
- Seeking reimbursement, indemnification, exculpation, or limitation of its liability from the private fund or its investors for the Private Fund Manager's breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund
- Reducing the amount of the Private Fund Manager's clawback by the amount of taxes (actual, potential, or hypothetical) applicable to the Private Fund Manager, its related persons, or their respective owners or interest holder
- Charging fees or expenses related to a portfolio investment on a non-pro rata basis (including non-pro rata allocations of "broken deal" expenses with respect to co-investment vehicles)
- Borrowing money, securities, or other assets, or receiving a loan or receiving an extension of credit from a private fund they manage

e. Preferential Treatment Rule

Proposed Rule 211(h)(2)-3(a)(1) and (2) would prohibit Private Fund Managers from providing preferential terms to certain investors unless disclosed to current and prospective investors. Specifically, Private Fund Managers would be prohibited from the following (unless disclosed):

- Providing information regarding the portfolio holdings or exposures of a private fund, or of a substantially similar pool of assets, if the manager reasonably expects that providing that information would have a material, negative effect on the other investors
- Providing preferential terms relating to redemptions to an investor in a private fund or a substantially similar pool of assets that the manager reasonably expects to have a material, negative effect on other investors or substantially similar pool of assets

These terms are often captured in side letters between Private Fund Managers and select investors and disclosed in general terms in the confidential offering memorandum of the relevant private fund. There is no guidance on what specific disclosure would be sufficient in order to comply with the proposed rule.

f. Related Books and Records Rule Changes

The Proposed Rules also include amendments to the existing books and records rule, Rule 204-2, which would require SEC-Private Fund Managers to retain records related to their compliance with the Proposed Rules.

II. Amended Annual Review Requirements

Also in this Release, the SEC proposed an amendment to the Advisers Act Compliance Rule 206(4)-7(b), which would be applicable to all SEC-registered investment advisers. As proposed, the amendment would modify the Compliance Rule by mandating that SEC-registered investment advisers document their annual review of compliance policies and procedures in writing.[5]

III. Amended Form PF Requirements

In a Release issued on Jan. 26, 2022, the SEC released Proposed Rules containing significant changes to Form PF and its associated filing requirements for SEC-Private Fund Managers, as set forth below.

a. New Current Reporting Requirement for Large Hedge Funds and Private Equity Funds

The proposed amendments to Form PF would require Private Fund Managers having at least $1.5 billion in regulatory assets under management (**RAUM**) attributable to hedge funds[6] to file current reports within one business day of the occurrence of any of the following reporting events:

- Extraordinary investment losses
- Significant margin and counterparty default events
- Material changes in prime broker relationships
- Changes in unencumbered cash
- Operations events
- Any event associated with withdrawals and redemptions

In addition, the proposed amendments to Form PF would also require SEC-Private Fund Managers to private equity funds to file

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[5] While SEC-registered investment advisers are currently required to conduct an annual review, the review is not required to be documented in writing (although in practice, many such advisers do, in fact, document such reviews in writing).
[6] RAUM is measured as of the end of any month in the prior fiscal quarter.

current reports within one business day of the occurrence of any of the following reporting events:

- Execution of secondary transactions led by such SEC-Private Fund Manager(s)
- Implementation of general partner or limited partner clawbacks
- Removal of a private fund's general partner
- Termination of a private fund's investment period, or termination of a private fund

b. Large Private Equity Fund Reporting

The proposed amendments to Form PF would reduce the threshold for SEC-Private Fund Managers reporting as large private equity advisers from $2 billion to $1.5 billion in private equity fund RAUM.

c. Large Liquidity Fund Reporting

The proposed amendments to Form PF would require SEC-Private Fund Managers to large liquidity funds to report substantially the same information that money market funds would report on Form N-MFP consistent with proposed amendments to Form N-MFP.

IV. New Cybersecurity Rule

In a second Release issued on Feb. 9, 2022, the SEC outlined Proposed Rules related to cybersecurity risk management for SEC-registered investment advisers, registered investment companies, and business development companies, as well as amendments to certain rules that govern their disclosures.

a. Cybersecurity Risk Management Rules

The Release includes Proposed Rule 206(4)-9 under the Advisers Act and Proposed Rule 38a-2 under the Company Act, which if adopted, would require SEC-registered investment advisers, registered investment companies, and business development companies to adopt and implement policies and procedures that are reasonably designed to address cybersecurity risks and associated operational risks that could harm clients and investors, or lead to the unauthorized access to or use of information, including the personal information of their clients or investors.

b. Reporting of Significant Cybersecurity Incidents

The Release includes Proposed Rule 204-6, which would require SEC-registered investment advisers to report significant cybersecurity incidents to the SEC, including on behalf of a managed private fund, registered investment company, or business development company, by submitting a new Form ADV-C. Form ADV-C would include both general and specific questions related to the significant cybersecurity incident, such as the nature and scope of the incident, as well as whether any disclosure has been made to any clients or investors.

c. Disclosure of Cybersecurity Risks and Incidents

The Release includes a proposed amendment to the Form ADV, Part 2A narrative disclosure requirements which would mandate disclosure of cybersecurity risks and incidents to an adviser's clients and prospective clients. It also includes a proposed amendment to Company Act rules which would require, in the relevant fund's registration statement, a description of any significant cybersecurity incidents that have occurred in the past two fiscal years, tagged in a structured data language.

d. Recordkeeping

The Release includes a proposed amendment to the existing books and records rule, Rule 204-2, which would require SEC-registered investment advisers to maintain records related to the proposed cybersecurity risk management rules and the occurrence of cybersecurity incidents. Similarly, Proposed Rule 38a-2 under the Company Act would require that registered investment companies and business development companies maintain copies of their cybersecurity policies and procedures and other related records.

V. Next Steps

The comment period associated with each Release and links to additional information related to each Release are provided in the table below. Lowenstein Sandler will monitor the status of the Proposed Rules and provide additional updates and analysis in future Client Alerts so that investment managers can determine whether changes are required to their existing compliance policies and procedures. Given the import of and significant changes contained in the Releases, we expect that the SEC will receive extensive comments during the relevant comment periods. As such, while there appears to be momentum for these proposals to pass, the final form of the rules may materially differ from the Proposed Rules. Please contact one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you have any questions regarding the Proposed Rules.

Release	Comment Period	Additional Information
New Rules for Private Fund Managers and Amended Annual Review Requirements	The later of 30 days after date of publication in the Federal Register or April 11, 2022	• Press Release • Fact Sheet • Proposed Rule
Amended Form PF Requirements for Private Fund Managers	30 days after date of publication in the Federal Register	• Press Release • Fact Sheet • Proposed Rule
New Cybersecurity Rule	The later of 30 days after date of publication in the Federal Register or April 11, 2022	• Press Release • Fact Sheet • Proposed Rule

Contacts

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