



State Association of County Retirement Systems Annual Fall Conference

**New SEC Rules & Their Impact on Public Pension Plan
Investors in Private Funds
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Speaker



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Agenda

- Introduction to Proposed Rules
- Application of Proposed Rules to Private Fund Advisers
- Overview of Proposed Rules
 - Prohibited Activities (Pro Rata Fees and Expenses, Fees and Expenses for Regulatory Compliance, Indemnification / Exculpation)
 - Preferential Treatment and Restrictions on Side Letters
 - Grandfathering / Timing
 - GP Secondaries
 - Private Fund Audits
 - Quarterly Statements
 - RIA Annual Compliance Reports

Introduction to the Proposed Rules

- On February 9, 2022, the SEC voted three-to-one to propose a set of new rules under the Investment Advisers

Areas Covered:

- Prohibited activities
- Private fund audit requirement
- Preferential treatment, including in side letters
- Adviser-led secondaries
- Quarterly statements
- Written documentation of the annual review

Proposed Rule Applicability:

- Certain proposed rules are not limited to private fund advisers that are registered or required to be registered with the SEC

The SEC's Concerns:

- The SEC is concerned that private fund advisers continue to follow practices contrary to the public interest and protection of investors:
 - Inadequate disclosure regarding fund fees and expenses and performance calculations
 - Opaque nature of private fund investments
 - Preferential treatment of certain larger investors
 - Undisclosed conflicts of interest and ineffective governance allows adviser overreach
- Without sufficient transparency, the SEC asserts that even sophisticated investors cannot make sound investment decisions

Application of the Proposed Rules to Private Fund Advisers

All Advisers to Private Funds

- Prohibit certain activities and practices that are contrary to the public interest
 - Certain fees and expenses
 - Seeking reimbursement or indemnification for certain items
 - Reducing a GP clawback for taxes
 - Charging fees/expenses on a non-pro rata basis
 - Borrowing from a private fund client
- Require disclosure to current and prospective investors of all types of preferential treatment
- Prohibit certain types of preferential treatment that have a material negative effect on other investors

Registered Investment Advisers (“RIAs”)

- Provide investors in private funds with quarterly statements detailing information about private fund performance, fees, and expenses
- Obtain an annual audit (and a final audit upon liquidation) for each private fund and require the auditor to notify the SEC of certain events
- Upon an adviser-led secondary transaction, distribute to fund investors a fairness opinion and written summary of certain material business relationships between the adviser and the opinion provider

Introduction to the Proposed Rules

NEW RULES

- On February 9, 2022, the new rules were initially proposed
 - The initial comment period closed on April 26, 2022
 - Comment letters were submitted by a wide range of stakeholders, including fund managers, limited partners and various industry groups
- On May 9, 2022, the SEC re-opened the comment period
 - Re-opened comment period closed on June 13, 2022
 - SEC has received a total exceeding 300 comment letters
- Adoption and compliance dates have not been stated, although the reg flex agenda suggests an April 2023 date
- Once adopted, private fund advisers would likely have a one-year transition period to comply with the final rules

Overview of the Proposed Rules

Proposed Prohibited Activities:

- Prohibited Fees/Reimbursements of or by a Fund:
 - Fees charged to a portfolio investment for services not provided
 - Governmental or regulatory exams or investigations of the private fund adviser or its related persons
 - Regulatory or compliance expenses of the adviser or its related persons
- Adjusting clawbacks for actual, potential, or hypothetical taxes
- Indemnification or exculpation of adviser's breach of fiduciary duty, willful misfeasance, recklessness, bad faith or negligence
- Non-pro rata fee or expense allocations as to particular investments
- Borrowing or receiving an extension of credit from a private fund client

Scope of the Prohibitions:

- The prohibitions on the activities would apply to all private fund advisers, regardless of their SEC registration status
- Further, the prohibitions would apply even if the activities are permitted by the fund's governing documents or consented to by investors or an advisory board

Overview of the Proposed Rules

Preferential Treatment and Restrictions on Side Letters:

- Currently, it is common for certain investors to receive “preferential” treatment, often through a side letter.
- The proposed rules would restrict the ability of private fund advisers and investors to negotiate terms.
- Under the proposed rules, all private fund advisers would be prohibited from:
 - Providing preferential redemption rights to a private fund investor, if the adviser “reasonably expects” that doing so would have a “material, negative effect” on other investors in the fund or a substantially similar pool of assets;
 - Providing preferential information to a private fund investor about the portfolio holdings or exposures of the private fund if the private fund adviser “reasonably expects” that doing so would have a “material, negative effect” on other investors in the fund or a substantially similar pool of assets; and
 - Agreeing to any other preferential treatment with a private fund investor, unless the preferential treatment is disclosed in writing to prospective investors prior to their investment in the applicable fund, and to existing investors annually
- The proposed rules would also amend the recordkeeping rule to require private fund RIAs to:
 - Retain all written notices sent to prospective and existing investors; and
 - Keep a delivery record (i.e., recipient, address, date sent, delivery method)

Overview of the Proposed Rules

Private Fund Audits:

- Currently, most SEC Private Fund RIAs that have custody of private fund assets conduct annual audits of the private fund's financial statements as a means of compliance with Advisers Act Rule 206(4)-2 (the Custody Rule); however, not every private fund arrangement where the adviser has custody involves an audit and there are other means of compliance
- Under the proposed rules, Private Fund RIAs would be required to:
 - Retain PCAOB-registered independent auditors to conduct audits of all private funds the Private Fund RIAs advise;
 - Cause audited financial statement to be prepared in accordance with U.S. GAAP (or foreign equivalent);
 - Promptly distribute the audited statements; and
 - Include in their written agreement with the auditor an obligation for the auditor to notify the SEC if it issues a modified opinion or resigns, is dismissed or is terminated from its engagement as auditor
- The proposed rules would require a SEC Private Fund RIA to retain a copy of the audited financial statements; keep a delivery record; and document the steps taken to cause the private fund client (not in a control relationship) to undergo a financial statement audit that complies with the proposed rule

Overview of the Proposed Rules

Quarterly Statements:

- While most private fund advisers provide periodic reports to investors, there is no requirement to do so under the Advisers Act
- The proposed rules, which would apply to SEC Private Fund RIAs, would standardize reporting content, form, and timing to private fund investors
- At the private fund level, statements would include a table detailing:
 - All compensation, fees, and other amounts allocated or paid to the Private Fund RIA by the private fund during the reporting period with a separate line item for each category that reflects a total dollar amount; and
 - All fees and expenses paid by the private fund during the reporting period with a separate line item for each category that reflects a total dollar amount other than those disclosed as adviser compensation
- At the portfolio company level, SEC Private Fund RIAs would be required to provide a table detailing, in respect of each “covered portfolio investment,” information on compensation and ownership percentage
- Also, the proposed rule would require reports to contain standardized fund performance information (depending on whether the fund is liquid or illiquid)

Overview of the Proposed Rules

RIA Annual Compliance Reports:

- Currently, Advisers Act Rule 206(4)-7 (the “Compliance Rule”) requires SEC Private Fund RIAs to review the adequacy of their compliance policies and procedures and the effectiveness of their implementation at least annually but does not expressly require written documentation of such review
- The proposed amendments to the Compliance Rule would require that every SEC Private Fund RIA document its annual review in writing (written documentation of the annual review) and provide such annual compliance reports promptly to the SEC upon request
 - The proposed amendments to the Compliance Rule do not dictate specific format or content for an annual review



Questions?



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