

INSIGHTS FROM THE BDO PRIVATE EQUITY AND ASSET MANAGEMENT PRACTICES

SEC'S NEW TRANSPARENCY RULES TARGET PRIVATE FUND ADVISERS



New rules aim to increase transparency, reduce the likelihood of fraud.

Compliance and technology departments may need to bolster headcount to keep up with additional documentation requirements.

Deadline for comments is April 11.

On Feb. 9, the U.S. Securities and Exchange Commission (SEC) proposed new rules and amendments to the Investment Advisers Act of 1940 directed at private fund advisers. The proposals would provide a statutory mandate for audits of private funds, enhance transparency to investors about the costs of investing in a private fund and the performance of such fund, limit and/or ban certain transactions or activities that represent a conflict of interest for the private fund adviser as well as prohibit certain sales practices that are contrary to the public interest and protection of investors.

The proposal anchors around five central areas, two of which would comprise all private fund advisers (i.e., registered and unregistered private fund advisers).

Proposal Affecting Registered Advisers¹

PRIVATE FUND AUDIT RULE

The Private Fund Audit Rule would require:

- ▶ Registered Advisers to have all of their managed private funds' financial statements undergo an audit at least annually and upon liquidation
- ▶ Such audits to be conducted in accordance with U.S. generally accepted audit standards (GAAS)
- ▶ Such audits to be performed by an accounting firm that
 - is registered with, **and subject to** inspection by, the Public Company Accounting Oversight Board (PCAOB)
 - maintains auditor independence in accordance with SEC independence rules²
- ▶ Notification by the accounting firm to the SEC for
 - any changes in the audit firm (e.g., through resignation, or dismissal)
 - any modified opinion that the accounting firm issues at the completion of the audit

BDO TAKEAWAY: For the most part, registered private fund advisers currently have the funds they manage undergo an annual audit as an option to satisfy the Custody Rule under the Act³. However, not all registered private fund advisers are subject to the Custody Rule, and even those that are subject to the Custody Rule are **not** required to obtain an audit in order to comply with the Custody Rule. Therefore, **in addition** to providing protection for the fund and its investors against the misappropriation of fund assets under the Custody Rule, the Private Fund Audit Rule will not replace, modify or substitute the Custody Rule. The SEC notes that the audit mandate would provide an important check on all registered advisers' valuations of private fund assets, which often serve as the basis for the calculation of the advisers' fees.

QUARTERLY STATEMENT RULE

(Fees and Expenses, and Fund Performance)

Through the quarterly statement rule, the Act proposes to increase transparency of information to investors about the cost of investing in a private fund and the private fund's performance.

Fees and Expenses: This rule would require registered private fund advisers to distribute to private fund investors a quarterly statement that details, in table format, the following:

- ▶ All compensation, fees and other expenses allocated or paid by the fund to the adviser or to any of its affiliates during the reporting period
- ▶ Other expenses paid by the fund
- ▶ Any offsets, rebates or waivers carried forward during the current reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its affiliates.

The proposed quarterly statement rule would also require advisers to disclose the following information with respect to any covered portfolio investment⁴ in a single table, as applicable to all such covered portfolio investments:

- ▶ A detailed account of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period
- ▶ The private fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period. If the fund does not have an ownership interest in the covered portfolio investment, the adviser would be required to list 0% as the fund's ownership percentage, along with a brief description of the history of the fund's investment in such covered portfolio investment.

¹ These also include advisers that are required to be registered.

² Rule 2-01(b) and (c) of Regulation S-X.

³ Rule 206(4)-2(a) under the Act.

⁴ Covered portfolio investment is a portfolio investment that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period.

Fund Performance: This disclosure is divided between private funds that are “illiquid” or “liquid” funds.

For illiquid funds⁵, the quarterly statement would be required to have performance information covering the period from inception through the end of the current calendar quarter covered by the statement, including:

- ▶ Gross and net internal rate of return for the fund
- ▶ Gross and net multiple of invested capital for the funds
- ▶ 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

The proposed rule also would require advisers to provide investors with a statement of contributions and distributions for the illiquid fund, detailing the capital inflows and outflows since inception by date for each cash in(out)flow and the amount of each in(out)cash flow, as well as the net asset value as of the end of the current quarter covered by the statement.

For liquid funds⁶, the quarterly statement would disclose fund performance information that includes:

- ▶ Annual net total returns for **each** calendar year since inception
- ▶ Average annual net total returns over the one, five and ten **calendar** year periods
- ▶ Cumulative net total returns for the **current calendar year** as of the end of the most recent calendar quarter covered by the quarterly statement

BDO TAKEAWAY: While private fund advisers may currently provide statements periodically to investors, there is no requirement for advisers to do so under the Act. The Quarterly Statement Rule proposal is designed to improve the quality of information provided to fund investors and allow them to better assess, monitor and analyze the value of their private fund investments, and to better compare their private fund investments. Additionally, it is worth noting that the proposed performance information for liquid funds is similar to those required for mutual funds.

ADVISER-LED SECONDARIES RULE

The proposal would require a registered private fund adviser to obtain a fairness opinion in connection with an adviser-led secondary transaction where the adviser offers fund investors the option to sell their interests in the private fund, or to exchange them for new interests in another of the adviser's vehicles. An independent opinion provider would opine on the fairness of the price being offered to the private fund for any assets being sold as part of the transaction. The proposal also would require the adviser to prepare and distribute to the private fund investors a summary of any material business relationships the independent opinion provider has or has had within the past two years with the adviser or any of its related persons.

BDO TAKEAWAY: Adviser-led transactions provide liquidity for investors and secure additional time and capital to maximize the value of fund assets. However, these transactions also raise certain conflicts of interest. Ensuring that the private fund and the investors that participate in the secondary transaction are offered a fair price is a critical component of preventing the type of harm that might result from the adviser's conflict of interest in leading the transaction. This rule requirement would provide a check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors.

⁵ “Illiquid funds” generally are closed-end funds that do not offer periodic redemption and they also do not invest in publicly traded securities, except for investing a de minimis amount of liquid assets. Most private equity, real estate and venture capital funds would fall into this category of funds.

⁶ Private funds that fall into the “liquid fund” definition generally are any private fund that is not an illiquid fund, allow periodic investor redemptions (such as monthly, quarterly, or semi-annually), are primarily invest in market-traded securities, except for a de minimis amount of illiquid assets. Most hedge funds would fall into the liquid fund category.

Proposals Affecting All Advisers⁷

PREFERENTIAL TREATMENT RULE

The preferential treatment rule eliminates the sales practice by **all** private fund advisers of providing preferential treatment regarding redemptions from the fund or information about portfolio holdings or exposures to investors. This proposal also prohibits these advisers from providing **any other** preferential treatment to any investor in the private fund, unless such treatment is disclosed to all current and prospective investors in writing.

BDO TAKEAWAY: Private fund advisers often provide preferential treatment to large investors for strategic reasons that benefit the adviser and also benefit the fund — for example, through increased fund assets that may enable the fund to make certain investments, to attract additional investors and to spread expenses over a broader investor and asset base.

However, there are scenarios where the preferential liquidity terms harm the fund and other investors. For example, if an adviser allows a preferred investor to exit the fund early and sells liquid assets to accommodate the preferred investor's redemption, the remaining investors may be left with a less liquid pool of assets, which can inhibit the fund's ability to carry out its investment strategy or promptly satisfy other investors' redemption requests.

PROHIBITED ACTIVITIES RULE

The prohibited activities rule is designed to reduce the likelihood of fraud by removing adviser incentives. The proposal would ban private fund advisers from:

- ▶ Charging certain fees and expenses to a private fund or its portfolio investments, such as fees for unperformed services (e.g., accelerated monitoring fees, servicing fees, consulting or other fees)
- ▶ Charging fees associated with an examination or investigation of the adviser
- ▶ Seeking reimbursement, indemnification, exculpation, or limitation of its liability for breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund
- ▶ Reducing the amount of an adviser clawback by the amount of certain taxes
- ▶ Charging fees or expenses related to a portfolio investment on a non-pro rata basis
- ▶ Borrowing or receiving an extension of credit from a private fund client

BDO TAKEAWAY: The SEC has observed certain conflicts of interest and compensation practices over the past decade that have persisted, despite the regulatory body's enforcement actions, and for which they believe disclosure alone will not adequately address. Accordingly, the SEC proposal is to outright ban these practices in order to prevent certain activities that could result in fraud and harm to investors.

⁷ Registered and unregistered advisers.

Summary and Takeaway

This SEC proposal comes at a busy time of the year for private fund advisers — and it also comes on the heels of two other rule proposals: the Cybersecurity Risk Management Rule for Advisers⁸ and the proposal to amend, and expand the disclosures in, Form PF⁹. While the additional SEC proposed requirements may not represent a seismic shift for large private equity and hedge fund advisers, they may be more consequential for mid-size and smaller private fund advisers. Across the board, the proposed changes to the Act mean that private fund advisers will face more compliance requirements. **As a result, compliance and technology departments may need to either bolster their headcount to support and keep up with the additional documentation requirements and monitoring surveillance for compliance or engage external firms to supplement their own resources.**

These proposed changes to the Act also reflect a move to boost transparency of costs and performance that are similar to those provided by mutual funds. The proposed standardized information will allow investors to understand the costs of a dollar invested and to evaluate the value derived from such costs through fund performance.

Advisers should closely monitor evolving developments to ensure operational and compliance readiness. Comments and feedback on the proposal are due the later of 30 days after publication in the Federal Register or April 11 (which is 60 days after issuance).

⁸ Proposed amendment issued on Feb. 9, 2022: <https://www.sec.gov/rules/proposed/2022/33-11028.pdf>

⁹ Proposed amendment issued on Jan. 26, 2022: <https://www.sec.gov/rules/proposed/2022/ia-5950.pdf>

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