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February 14, 2022

SEC Proposes New Rules to Protect Private Fund Investors

On February 9, 2022, the U.S. Securities and Exchange Commission ("SEC") proposed new rules and amendments to enhance private fund investor protection. While the proposed new and amended rules would amend the Investment Advisers Act of 1940 (the "Investment Advisers Act"), several are also applicable to private fund advisers exempt from registration under the Investment Advisors Act. The SEC defines "private funds" as pooled investment vehicles excluded from the definition of "investment company" under sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") and therefore exempt from registration under it; private equity and hedge funds are generally exempt. However, the Dodd-Frank Act of 2010 tightened up the definition of "Investment Advisers" exempt from registration under the Investment Advisers Act to those exclusively advising venture funds and exclusively advising private funds with less than $150 million in assets under management in the U.S., and as a result, many investment advisers have been required to register with the SEC under the Investment Advisers Act even though their funds are exempt from registration under the Investment Company Act. The SEC's proposed new rules and amendments are therefore of concern to advisers and their affiliates, both registered and unregistered, of many private equity, hedge funds, venture funds and other private funds as well as advisers to registered investment companies like large mutual funds.

The proposed new rules and amendments would:

- Require private fund advisers registered with the SEC to provide

investors with quarterly statements containing detailed information on fund performance, fees and expenses as well as information regarding compensation and other amounts paid by fund's portfolio investments to the adviser and related persons. The fund performance quarterly information to be provided to investors would include, for liquid funds, annual net total returns since fund inception, average annual net total returns during prescribed time periods, and quarterly net returns for the current calendar year. For illiquid funds, the fund performance quarterly information to be provided to investors would provide the gross and net internal rate of return and gross and net multiple of invested capital for the fund to show performance from fund inception through the end of the then-current calendar quarter. The SEC states that the proposal should improve the quality of information distributed to investors and allow them to better assess, monitor and compare fund performance;

- Require registered fund advisers to obtain an annual audit for each private fund and an audit upon liquidation, and and cause the private fund's auditor to notify the SEC upon the occurrence of certain events, with the audit results to be distributed to investors promptly upon completion. The SEC states that the audit would provide an important check on valuation of fund assets, which are often used to calculate fund advisers' fees, and protect investors against misappropriation of fund assets;

- Require registered private fund advisers, in connection with an adviser-led secondary transaction, to obtain and distribute to investors an independent fairness opinion and a written summary of certain material business relationships between the adviser and the fairness opinion provider. The SEC states that in secondary transactions, private fund advisers often offer existing investors the option to sell or exchange their fund interests for interests in another vehicle advised by the fund adviser. An independent fairness opinion will opine on the fairness of the price being offered to investors to sell into the transaction. The proposal would also require the fund adviser to prepare and distribute to fund investors a summary of any material business relationships the fairness opinion provider has or has had within the preceding two years with the adviser or related persons, as a check against advisers' potential conflicts of interest in profiting from the secondary transaction at fund investors' expense and the independence of the fairness opinion provider;

- Prohibit all private fund advisers, including those that are not registered, from engaging in certain activities and practices that are contrary to the public interest and protection of investors. Among the prohibited activities would be:

    - charging certain fees and expenses to a private fund or its

portfolio investments, such as fees for unperformed services like accelerated monitoring fees;

- seeking reimbursement, indemnification, exculpation or limitation of liability for certain activities;
- 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; and
- borrowing or receiving an extension of credit from a private fund client; and

- Prohibit all private fund advisers from providing certain types of preferential treatment to investors that have a material negative effect on other investors, such as fund redemption or information about portfolio holdings or exposures, while also prohibiting all other types of preferential treatment (i.e., including preferential treatment that does not have a material negative effect on other investors) unless disclosed to both current and prospective investors.

The proposed new rules and amendments are available **Here** and will remain open for public comment for 60 days following publication on the SEC website or 30 days from publication in the Federal Register, whichever is longer. Further information is available on our website at **Kurtin PLLC Private Equity, Venture Capital and other Financial & Strategic Investments** and **Kurtin PLLC Whitepapers and Advisories**.

For additional information, please contact us at **info@kurtinlaw.com**.

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