CLEARY GOTTLIEB

ALERT MEMORANDUM

Gensler Goes to the Mattresses:

Proposed Rules for Private Fund Advisers Aim to Protect Investors (Including From Themselves)

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On February 10, 2022, the U.S. Securities and Exchange Commission ("SEC") proposed dramatic new rules under the Investment Advisers Act of 1940 (the "Advisers Act") that would significantly impact private fund advisers' disclosure and reporting obligations as well as, in a momentous change in the SEC's approach to private funds, prohibit certain commercially negotiated features (the "PE Proposal"). The SEC also proposed amendments to reporting and compliance requirements for all registered advisers relating to cybersecurity incidents (the "Cybersecurity Proposal"). Notably, the PE Proposal would prohibit all advisers to private funds from charging certain fees and expenses to private fund clients or portfolio investments, calculating adviser clawback obligations on after-tax basis or seeking indemnification or otherwise limiting liability for breaches of fiduciary duty, willful misfeasance, bad faith, recklessness or even negligence. The PE Proposal strikes at side letters and similar commercially negotiated preferential agreements with investors, banning certain provisions and requiring disclosure of all others.

Below is a summary of our headline observations and notable points from the PE Proposal (available here) and the Cybersecurity Proposal (available here), along with specific interpretive issues that the industry will want to consider during the comment period. The comment period for the both proposals will remain open until the later of (i) 60 days from publication online and (ii) 30 days from publication in the Federal Register.

Headline Observations

—The SEC introduces the PE Proposal by noting that "private funds typically lack governance mechanisms that would help check overreaching by private fund advisers. For example, although some private funds may have limited partner advisory committees ("LPACs") or boards of directors, these types of bodies may not have the necessary independence, authority, or accountability to oversee and consent to these conflicts or other harmful practices…To the extent investors are afforded governance or similar rights, such as LPAC representation, certain fund agreements permit such investors to exercise their rights in a manner that places their interests ahead of the private fund or the investors as a whole." This is a worrying regulatory flag to plant given that LPAC disclosure and consent sits at the heart of both commercial and regulatory features of governance, and has been the bedrock of mitigating conflicts of interest for decades. LPAC consent rights are highly negotiated, as are the related limitations on liability for LPAC members, and individual investors are unlikely to agree to undertake any duty towards the broader investor pool in exchange for an LPAC seat. If the SEC continues in this vein, advisers may be left without an operationally effective way to clear conflicts, short of seeking consents from their investor pool writ large. Moreover, in our experience LPACs are effective in providing independent views and checks on these matters.

—The PE Proposal provides for a one year transition period, but does not indicate how most of these changes will be applied to current fund documents, which are highly negotiated and routinely contain provisions that conflict with even the most straightforward of the proposed rules. Some of the proposals would rewrite bargained-for agreements in a way that undermines the certainty of a contract (as looks to be the case with the prohibition on an after-tax limitation to adviser clawbacks). Moreover, the impact for funds with lives that are over a decade would be extreme. The SEC's prohibitions on long-standing market practices are also concerning, because they signal a willingness to ban practices that the SEC doesn't like, even when such practices are highly negotiated by sophisticated parties. The SEC's approach reflects a drastic shift from a principles-based approach that permits well-informed, sophisticated investors to negotiate for themselves.

—The devil is in the details, with many of the more seismic concepts not appearing in the proposed new rules themselves but rather posed as comment prompts and footnote dicta. Included on this list is request for comment on a possible ban on 2 and 20 performance compensation, a cap on management fees, and a ban on "American waterfalls" that calculate performance compensation on a deal by deal basis. While these points seem unlikely to end up in the final rule, they also send a strong signal that the SEC believes all options are on the table for enhanced regulation.

—The SEC Division of Enforcement has shown an increased desire to bring standalone enforcement actions for policy and procedure violations and failure to file required forms or maintain required records, disclosure or other violations, even in the absence of fraud. Gurbir Grewal, the Director of the Division of Enforcement, has called this "proactive enforcement" in recent remarks (available here), in language suggesting a return to "broken windows" enforcement. One example is actions for failure to file Forms CRS. When viewed through this lens, the PE Proposal and the

Cybersecurity Proposal, combined with the proposed Form PF expansion released on January 26, 2022 (the "Form PF Proposal," discussed here), provide ample grist for the enforcement mill, with the "principles-based" rule approach espoused so recently in the 2020 Marketing Rule release (discussed here) replaced by templates, mandatory reports and granular prohibitions that will inevitably facilitate hindsight scrutiny in investigations and examinations.

Private Fund Quarterly Statements

Overview and Timing. The PE Proposal requires registered advisers to prepare and distribute to investors a quarterly statement for any private fund that it advises within 45 days of the end of each calendar quarter. Advisers would be required to consolidate reporting for "substantially similar" pools of assets (such as feeders or parallel funds) to the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading.

This reporting would be in addition to the quarterly reports currently provided by qualified custodians in Rule 206(4)-2 under the Advisers Act (the "Custody Rule") and the annual financial statements provided under either the Custody Rule or the new audit requirement (discussed below). While quarterly reporting is standard market practice for private funds, the reports are currently highly tailored to suit both the adviser's business and investors' demands, with the substance of fund reports often proscribed in the fund's governance documents and side letters and benchmarked to industry best practice, such as the templates published by the Institutional Limited Partners Association ("ILPA"). The PE Proposal would require advisers to either re-negotiate such provisions or produce dual sets of reports, and would impose heavy compliance burdens, especially on small or newly formed advisers. 45 days is also an aggressive timeline to complete the necessary valuations and itemized calculations required by the PE Proposal, particularly for smaller managers, secondaries funds and funds-of-funds. We expect significant comment on the proscriptive content of the required quarterly statements and the compliance cost.

Fee and Expense Disclosure. Quarterly statements would need to include fund-level disclosure setting out a detailed accounting (broken out by line items) of (i) all compensation, fees, and other amounts allocated or paid to the adviser or its "related persons", including compensation for consulting, legal or back-office services, (ii) all fees and expenses otherwise paid by the private fund and (iii) the amount of any offsets or rebates carried forward. Advisers would also have to disclose their compensation and fund expenses both before and after the application of any offsets, rebates, or waivers. The SEC has sought comments regarding personalized quarterly statements, that would show each individual investor's fees, expenses, and performance, rather than showing information on a fund-wide basis.

At the portfolio level, advisers would be required to disclose (i) a detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment to the adviser or its related persons during the reporting period (including fees for origination, management, consulting, monitoring, servicing and administration and directors' compensation) and (ii) the private fund's ownership percentage of each such covered portfolio investment as of the end of the reporting period.

"Covered portfolio investments" are those which paid the adviser or its related persons compensation during the reporting period. A "portfolio investment" is any entity or issuer in which the private fund has invested directly or indirectly. In addition to simple portfolio company interests, this definition captures any entity or issuer in which the private fund holds an interest, including indirect interests through holding companies, subsidiaries, acquisition vehicles and special purpose vehicles. As a result, the proposed definition may capture more than one entity or issuer with respect to any single investment made by a private fund.

Compensation to Related Persons. The proposed definition of "related person" for purposes of fee disclosure is consistent with the current definition in Form ADV, which covers (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser. "Control" for this purpose also applies the Form ADV definition, which covers actual control as well as presumed control where there is a 25% voting or economic interest (varying by entity type). The PE Proposal also notes that the definition is designed to capture the various entities and personnel an adviser may use to provide advisory services to, and receive compensation from, private fund clients, suggesting that compensation received by employees of an adviser's affiliate would also be subject to disclosure.

While the 25% threshold for control would already cover a large swath of the adviser's affiliate relationships, the SEC seeks comment on whether to lower the threshold to 5%. The SEC also seeks comment on whether to broaden this definition even further to capture (i) former personnel, (ii) family members and roommates of current personnel, or (iii) operating partners, senior advisors or other similar consultants.

Methodology disclosure. Each statement must include prominent disclosure regarding the manner in which compensation is calculated. The quarterly statement also must include cross references to the relevant sections of the private fund's organizational and offering documents that set forth the calculation methodology. While this is purportedly to facilitate "an investor's ability to seek additional information," realistically such cross-references are likely to better serve as a tool for examinations and investigations.

Performance disclosure for liquid and illiquid funds. The PE Proposal requires advisers to include standardized fund performance information in each quarterly statement.

Advisers to "liquid funds" must show (1) annual net returns for each calendar year since inception; (2) average annual net total return over a one-, five-, and ten calendar year period; and (3) cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.

Advisers to "illiquid funds" must show (1) gross and net internal rate of return ("IRR") and multiple of invested capital ("MOIC") for the full fund and (2) separate gross IRR and gross MOIC (i.e., no net) for the realized and unrealized portions of the illiquid fund's portfolio, respectively. They must also provide a statement of contributions and distributions for the illiquid fund, covering (1) all capital inflows to investors and capital outflows to investors since inception and (2) the net asset value of the fund as of the end of the reporting period.

Performance information would be required without the benefits or costs of any fund-level subscription facilities. Instead, the amount borrowed under the subscription facility would be required to be reflected as a capital inflow from investors and an equal dollar amount of actual capital inflows from investors generally should not be reflected on the statement. Similarly, costs of borrowing would be excluded from the calculations. While some private fund advisers currently show IRR pro forma for borrowing as the SEC suggests, many show it only on an investor cash flow basis. In these cases, advisers would have to recalculate performance and the result would not reflect and investors' true IRR.

It is not clear whether the rules would also require advisers to disclose after-tax IRRs. Typically private fund advisers do not show returns that reflect investor-level taxes (such as withholding, or certain taxes associated with bespoke investment structures that have been requested by investors) and it likely is not feasible to require this level of disclosure, given the array of investor-specific tax attributes.

Overlap with the Marketing Rule. Woe to early adopters of the Marketing Rule! The more proscriptive template required for quarterly statements under the PE Proposal compared to the Marketing Rule will require those advisers who have begun planning and modifying systems to comply with the Marketing Rule to do additional compliance work. This includes new proscribed calculation methods for IRR and MOIC and the addition of a one-, five-, and ten-calendar year periods lookback for liquid fund performance, despite private funds being exempted from this lookback under the Marketing Rule.

Notably, the PE Proposal would only require an adviser to disclose gross (not net) performance measures for the realized and unrealized portions of the illiquid fund's portfolio, stating that the SEC staff "believe that calculating net figures could involve complex and potentially subjective assumptions regarding the allocation of fund-level fees, expenses, and adviser compensation between the realized and unrealized portions of the portfolio. In our view, such assumptions would likely diminish the benefits net performance measures would provide." This sentiment is shared by the bulk of our adviser clients, who had urged unsuccessfully that the SEC take the same approach under the Marketing Rule. If the PE Proposal does indicate a policy change, hopefully this relief would also be provided for the Marketing Rule.

While the Marketing Rule only applies to investor periodic reports to the extent information is intended for current investors who rely on this information in determining whether to invest in subsequent funds or opportunities with the same adviser, (and the PE Proposal does not purport to modify the Marketing Rule), advisers should treat this as outside the scope of the Marketing Rule at their peril. The moment a quarterly statement is provided to a prospective investor, or used in discussions with existing investors as part of solicitation of them, the Marketing Rule will apply. Moreover, the general antifraud rules and the SEC staff's 2019 Fiduciary Duty Guidance (discussed here) would still apply regardless of whether the quarterly statement is considered an "advertisement" under the Marketing Rule.

Scope of the Rule. While the rule as proposed would only apply to registered advisers and their 3(c)(1) and 3(c)(7) funds clients, the SEC requests comment on expanding the scope of the rule to apply to (i) exempt reporting advisers ("ERAs"), who are currently exempt from the Marketing Rule, or "any other advisers to private funds" – which could pick up advisers who are generally excluded from the Advisers Act such as family offices and foreign private advisers, and (ii) other types of pooled investment vehicles, such as 3(c)(5) clients (e.g., certain real estate funds). The PE Proposal is silent on the application of the rule to the non-US clients of offshore advisers; however non-US clients were explicitly carved out of the Marketing Rule on the basis that the Marketing Rule forms part of the "substantive requirements" of the Advisers Act that do not apply to offshore advisers' non-US clients. We are hopeful that this will be clarified in the final release and made consistent with the Marketing Rule.

A Warning Shot Across the Bow. Perhaps to make the quarterly reporting requirements seem palatable by comparison, the PE Proposal seeks comment on a series of far more extreme measures to regulate private fund fees and expenses. Specifically, the PE Proposal asks:

> *Are there alternative approaches we should require to improve investor protection and bring greater efficiencies to the market? For example, should we establish maximum fees that advisers may charge at the fund level? Should we prohibit certain compensation arrangements, such as the "2 and 20" model? Should we prohibit advisers from receiving compensation from portfolio investments to the extent they also receive management fees from the fund? Should we require advisers to disclose their anticipated management fee revenue and operating budget to private fund investors or an LPAC or other similar body (despite the limitations of private fund governance mechanisms, as discussed above) on an annual or more frequent basis? Should we impose limitations on management fees (which are typically paid regardless of whether the fund generates a profit), but not impose limitations on performance-based*

compensation (which is typically tied to the success of the fund)? Should we prohibit management fees from being charged as a percentage of committed capital and instead only permit management fees to be based on invested capital, net asset value, and other similar types of fee bases? Should we prohibit certain expense practices or arrangements, such as expense caps provided to certain, but not all, investors?

Prohibitions or limitations on these categories of performance compensation would upend the basic economics of the private fund industry, and we expect uniform and strong push back on these proposals in the comment period.

Private Fund Adviser Audits

The PE Proposal would require registered advisers to obtain an annual GAAP audit of private funds that they advise (directly or indirectly). An audit would also be required upon liquidation. The SEC notes that these audits are intended to both protect investors against misappropriation of fund assets and mitigate the conflicts of interest which arise when advisers set their own asset valuations. Such conflicts allegedly include the calculation of advisory fees on the basis of such valuations (where, we note, the antifraud rules and the Fiduciary Duty Guidance already apply to any miscalculations), and inclusion of such valuations in performance track records used for marketing new funds (which, we note, would already be subject to the rigorous protections of the Marketing Rule).

Under the PE Proposal, audited financials must be distributed to fund investors 'promptly' after the audit is completed (with the Custody Rule's existing 120 day deadline as a guidepost but not a requirement). Auditors would have a separate obligation to notify the SEC if they have been terminated or if they have issued an audit with a qualified opinion (information that is currently required annually on Form ADV). Sub-advisers would also be obligated to ensure that an audit is carried out for the unaffiliated private funds they advise.

Overlap with the Custody Rule. The PE Proposal notes that the new audit requirement is based on the current Custody Rule and that the financial statement audit performed under either rule would be the same. However, compliance with one rule will not automatically satisfy the requirements of the other. In particular, the Custody Rule can be satisfied by annual surprise examinations instead of annual audits, an option that is often chosen by advisers who produce non-GAAP financial statements that cannot be easily reconciled to GAAP. Under the PE Proposal, such advisers would have no alternative to a GAAP reconciliation, regardless of the financial statements that are most appropriate for the relevant fund's investors or that may be required by overseas regulators (particularly with respect to European alternative investment fund managers).

The Custody Rule also provides for several exceptions to the surprise examination requirement that, by extension are also alternatives to an annual audit alternative, such as, for example, when an adviser has custody solely because of its authority to deduct advisory fees from client accounts. These exceptions would not be available under the PE Proposal. While the SEC justifies this change by saying such exemptions were not regularly used by private fund advisers, the new rule seems on its face an attempt to tighten the Custody Rule's restrictions short of an amendment, and we expect going forward that few if any private fund advisers would chose to implement a surprise examination in addition to the newly required annual audit.

Scope of the Rule. While the rule as proposed would only apply to registered advisers and their 3(c)(1) and 3(c)(7) funds clients, the SEC requests comment on expanding the scope of the rule to apply to (i) ERAs, who are currently exempt from the Custody Rule, (ii) other types of pooled investment vehicles, such as 3(c)(5) clients, or (iii) any advisory client with financial statements that can be audited. The PE Proposal is silent on the application of the rule to the non-US clients of offshore advisers. As such clients have long been excluded from the coverage of the Custody Rule, and both rules fall under the authority of Section 206(4) of the Advisers Act, we are hopeful that this will be clarified in the final release to be made consistent with the Custody Rule. The PE Proposal is also silent on the application of the rule to certain co-invests and other vehicles that advisers may not treat as advisory clients. Given the highly negotiated and tailored nature of these vehicles, we question why the SEC has posed this question other than to provide a warning to the industry about the practice of not counting such pooled investment vehicles as clients covered by the Custody Rule.

Finally, because annual audits are a cost to investors, requiring an audit upon an entity's liquidation introduces a new burden for advisers and results in a more costly liquidation procedure for investors. Expanding the scope of the annual audit requirement to cover ERAs and other advisory clients would similarly increase costs to those investors.

Prohibited Activities for All Advisers

The most groundbreaking aspect of the PE Proposal is the prohibitions on long-standing market practices that in our experience are heavily negotiated and fundamentally commercial issues. The PE Proposal prohibits all advisers, regardless of registration status, from engaging in certain sales practices, conflicts of interest, and compensation arrangements that the SEC has determined "are contrary to the public interest and the protection of investors." Offshore advisers are exempt from these restrictions with respect to their non-US clients.

Fees for Unperformed Services. The PE Proposal would prohibit an investment adviser from charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide. While the PE Proposal specifically refers to payments under acceleration clauses, the rule itself refers to any unperformed services and would cast a much wider net to capture any discrepancies between fees charged and services performed. We expect this prohibition would be used as an examination and enforcement tool to challenge upfront transaction fees and regular monitoring fees from both a substantive and documentation perspective. Compliance teams should prepare to defend the validity of an adviser's services fees, particularly where termination of service agreements are not accompanied by a refund or true-up. The SEC also notes that it does not intend to prohibit arrangements where the adviser shifts 100% of the portfolio fee benefit to investors (e.g., through management fee offset) but that private funds with a 100% management fee offset would not comply with the proposed rule if there are excess fees retained by the adviser where no further management fee offset can be applied and in circumstances where investors are not given the option to participate in excess fees at the liquidation of the fund. The SEC asks for comment on how to apply this 100% fee offset concept in the context of tax-sensitive investors, which may not want to receive the benefit of excess fees.

Compliance Costs. The PE Proposal prohibits advisers from charging a private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, as well as regulatory and compliance fees and expenses of the adviser or its related persons.

The PE Proposal provides a carve-out for expenses directly related to the activities of the private fund (for example, costs associated with a regulatory filing of the fund, such as Form D), although the SEC notes that it would be a violation of the antifraud rules if the fund's organizational documents do not provide for the payment of these costs and expenses. However, it is not clear if this carve out would cover the requirements introduced by the PE Proposal itself, namely the cost of the newly required annual audits and quarterly financial statements.

Reducing Adviser Clawback for Taxes. The PE Proposal prohibits an adviser from reducing the amount of any performance allocation clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders. The requests for comment also ask about prohibiting "American waterfalls" which calculate performance compensation on a deal by deal basis (in contrast to "European waterfalls" which calculate performance compensation on a whole-fund basis).

This is one of the most aggressive parts of the PE Proposal, and we expect significant pushback. Clawbacks are highly negotiated terms, and are part of broader economic negotiations with sophisticated investors that agree on specific commercial arrangements. Applying a post hoc modification to such provisions in existing funds would effectively rewrite contracts and terms specifically negotiated in good faith. It can also have a devastating financial impact on advisers that have relied on the benefit of their bargained for agreement. It's worth noting that while ILPA made a push to eliminate after-tax clawbacks over a decade ago, they subsequently removed this concept from their principles, recognizing the rationale behind the practice and the prevalence of it within the industry. In addition, the after-tax limitation on the clawback reflects the fact that in situations where the adviser has borne a tax burden, generally it means that the adviser was allocated taxable income rather than the limited partners being allocated the income.

Limiting or Eliminating Liability for Adviser Misconduct. The PE Proposal prohibits advisers from seeking indemnification or a limitation of liability from a private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, recklessness or even negligence in providing services to the fund. The SEC has long focused on the boundaries of contractual provisions that purport to limit an adviser's liability ("hedge clauses"), and the Fiduciary Duty Guidance withdrew prior no-action guidance that had been interpreted by some in the industry as expanding the ability of investment advisers to private funds, and potentially other sophisticated clients, to disclaim their fiduciary duties under state law in an advisory agreement. In the Fiduciary Duty Guidance, the staff reiterated that "an adviser's federal fiduciary duty may not be waived, though its application may be shaped by agreement." The staff's 2022 Risk Alert (available here) noted that the Division of Examinations have observed potentially misleading hedge clauses that purported to waive or limit the Advisers Act fiduciary duty except for certain exceptions, such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud, and the staff have increased enforcement activity with respect to such hedge clauses. Limiting use of hedge clauses also has been a high priority for ILPA.

That being said, the PE Proposal goes far beyond these prior statements and industry expectations, particularly with its ban on limiting liability for simple negligence as opposed to the gross negligence industry standard. This appears to be another attempt by the SEC to disregard the contractual arrangements negotiated by sophisticated investors, significantly altering the relationship of parties mid-course and opening the door to a wave of potential litigation. The SEC's proposal expands beyond even the requirements of public companies with retail investors, who routinely indemnify management personnel and certain employees for simple negligence.

We expect this ban on indemnification and exculpation provisions to be the source of some of the most significant pushback from the industry on this proposal, including challenges to the SEC's authority to adopt this rule. And while we hope the final proposal will restore the boundary between simple and gross negligence, advisers would be wise in any case to review the limitation of liability provisions in their advisory agreements and explore other alternatives for managing the risk of litigation costs (such as expanded insurance coverage).

Pro rata Fee and Expense Allocation. The PE Proposal prohibits advisers from charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment, including broken deal expenses.

While the PE Proposal would generally apply to co-invest vehicles, a footnote actually carves out from allocations of broken-deal expenses a co-investor that has not executed a binding agreement to participate in the transaction (with a note that failing to adequately disclose the non-pro rata allocation in such circumstances would be a violation of the antifraud rules). In our experience, investors in co-invest vehicles are very focused on not paying broken deal expenses, often because whether a deal closes or fails is out of their control. As a result, this rule may have the perverse outcome of encouraging co-invest vehicles to sign commitments after a fund has closed the transaction, in order to avoid broken deal expenses, forcing funds to either bypass larger deals (where they rely on co-invest commitments) or take on excess investment capacity in the hope that co-invest vehicles will join after the deal has been consummated. Advisers would not be prohibited from charging vehicles that invest alongside each other different advisory fees or other fund-level compensation. For example, a co-invest vehicle may continue to pay lower management fees than the main fund, and an adviser may continue to charge different management fees than its related persons.

Borrowing. The PE Proposal prohibits all private fund advisers from directly or indirectly borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client, even with the specific and informed consent of investors. The PE Proposal suggests this limitation also applies to the related persons of advisers, which could include parallel employee funds or other private funds in which the adviser (or its affiliates) has a 25% or greater interest.

Because of the limit on indirect borrowing, this prohibition could have unintended consequences, such as prohibiting tax advances or arrangements where private funds cover the costs of certain expenses but are ultimately refunded by the adviser via fee offsets (e.g., organizational expenses and placement fees). Such arrangements can be crucial for small advisers when launching their advisory businesses.

The PE Proposal would not prevent the adviser from borrowing from a third party on the fund's behalf or from lending to the fund.

Adviser-Led Secondaries

The PE Proposal requires registered advisers to obtain a fairness opinion in connection with adviser-led secondary transactions where an adviser offers fund investors the option to sell their interests in the private fund, or to exchange them for new interests in another vehicle advised by the adviser. The adviser must also disclose any "material relationships" between the adviser and the fairness opinion provider within the past two years.

Adviser-led secondaries were also a focus of the Form PF Proposal, which introduced a current report requirement for each such transaction. While current market practice generally includes fairness opinions for investors participating in many adviser-led secondary transactions, advisers and investors may sometimes prefer lower cost alternatives such as pegging prices to third party bids or other independent sources because the cost for a fairness opinion is born by investors. Adviser-led secondary transactions are generally offered to investors as a commercial accommodation, and as an optional source of liquidity, and typically require consent of an LPAC or other conflicts body. The proposed disclosure requirements, coupled with the proposed Form PF reporting, therefore seem more geared towards providing a tool for examinations and investigations than for investor protection.

Preferential Treatment

The PE Proposal prohibits all private fund advisers, regardless of registration status, from providing certain preferential terms to specific investors. It also generally requires disclosure of all preferential arrangements, however documented, on both a pre-investment and annual basis. Whether any terms are "preferential" would depend on the facts and circumstances. This requirement does not apply to separately managed accounts, but does apply to "substantially similar pools of assets," which could include side cars, parallel funds, alternative investment vehicles and any other entities that have substantially similar investment policies, objectives or strategies to the private fund. Notably, proprietary accounts of the adviser or its related persons might be considered substantially similar pools of assets.

Prohibited Preferential Terms. The PE Proposal prohibits advisers from granting an investor the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets. When implemented in practice, the material negative effect standard may require an adviser to do considerable work, as a large body of preferential redemption provisions are related to the tax or other regulatory requirements of a particular investor, and as such may not be appropriate (or relevant) for all investors. Likewise, substantially similar pools of assets (like parallel vehicles) are often created as a tax or regulatory accommodation for certain investors and have corresponding differences in redemption provisions.

In the PE Proposal there is no exception for preferential terms that may simply reflect differences in tax status among investors or similar regulatory distinctions (e.g., under ERISA rules); investors today commonly have opt out or excuse rights, structuring covenants, reporting, or other information rights that relate to their tax status and internal policies related to that status.

The adviser and its related persons are also prohibited from providing information regarding the portfolio holdings or exposures of the private fund or of a substantially similar pool of assets to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets. The SEC states that selective disclosure of portfolio holdings or exposures can result in profits or avoidance of losses among those who were privy to the information beforehand at the expense of investors who did not benefit from such transparency, or can enable an investor to trade in portfolio holdings in a way that "front-runs" or otherwise disadvantages the fund or other clients of the adviser. We note that investors are generally contractually restricted from trading on material nonpublic information they receive from an adviser and using that information for other purposes, so this proposal seems to be targeting inappropriate investor behavior by policing the advisers. Moreover, unlike preferential economic terms, it is hard to imagine material, negative effects beyond the cited example. This selective disclosure prohibition is more restrictive than Regulation FD, which only applies to public companies. We expect significant comment on this aspect of the PE Proposal.

Prohibition of Other Preferential Terms Without Disclosure. The PE Proposal prohibits advisers from providing any other preferential treatment to any investor in a private fund unless the adviser provides: (1) written pre-investment disclosures to prospective and current investors regarding all preferential treatment the adviser or its related persons are providing to other investors in the same fund and (2) annual written information about any preferential terms provided. Notably, the PE Proposal would require advisers to disclose the actual preferential terms, such as actual different fee rates, because simply disclosing the existence of different terms would not satisfy the rule.

The disclosure requirement captures (1) preferential treatment by either the adviser or its related persons (acting on their own behalf and/or on behalf of the fund) and (2) both formal side letters and informal communications and email agreements.

While disclosure of material side letter terms is often common practice, and is often required by MFN clauses with primary investors, the requirement to disclose preferential terms pre-investment may slow down fundraising and opens the door for prolonged negotiation. It also would require disclosures of information that may not be picked up by MFN, like multi-fund "frequent flyer" discounts that are often bespoke and highly negotiated. Likewise, the ongoing reporting requirement will create another fact heavy disclosure document that compliance personnel must ensure is entirely consistent with underlying side letter contractual provisions and Form ADV disclosures, making it another tool for examinations and investigations focused on whether, in hindsight, disclosures have captured the appropriate level of detail.

Cybersecurity Proposal

While it has attracted considerably less fanfare than the PE Proposal, the Cybersecurity Proposal includes comprehensive reforms for registered advisers regarding cybersecurity risk management policies and procedures, mandatory reporting of certain cybersecurity incidents to the SEC (including a new Form ADV-C), and mandatory disclosures to investors and other market participants (including amendments to existing Form ADV Part 2A).

Required Cybersecurity Risk Management Policies and Procedures. The Cybersecurity Proposal requires registered advisers to implement cybersecurity policies and procedures addressing a number of specific elements, including (a) periodic risk assessments that assess, categorize, prioritize, and document cybersecurity risks associated with information systems and the information residing in those systems; (b) minimization of user-related risk and prevention of the unauthorized access to information and systems; (c) protection of information from unauthorized access or use, as well as documented oversight of relevant service providers; (d) detection, mitigation, and remediation of cybersecurity threats and vulnerabilities; and (e) measures to detect, respond to, and recover from cybersecurity incidents, which include an unauthorized occurrence on or conducted through an adviser's or a fund's information systems that jeopardizes the confidentiality, integrity, or availability of such information systems or any adviser or fund information residing therein. Such policies would be subject to annual review and proscribed compliance recordkeeping.

Reporting on Form ADV-C. The Cybersecurity Proposal requires advisers to report "significant cybersecurity incidents" affecting the adviser or its private fund clients to the SEC on a confidential basis. A significant adviser cybersecurity incident is one that (a) significantly disrupts or degrades the adviser's ability, or the ability of a private fund client of the adviser, to maintain critical operations or (b) leads to the unauthorized access or use of adviser information, where the unauthorized access or use of such information results in: (1) substantial harm to the adviser, or (2) substantial harm to a client, or an investor in private fund, whose information was accessed. The new Form ADV-C would be submitted by an adviser no later than 48 hours after having a reasonable basis to conclude that a significant adviser cybersecurity incident had occurred or is occurring with respect to itself or any covered clients (including registered investment companies, business development companies and private funds). Advisers would be required to file an amended Form ADV-C if any of the previously reported information becomes materially inaccurate or new material information has come to light, and to file a final Form ADV-C amendment after the resolution of any significant cybersecurity incident or after the closing of any related internal investigation. Information in new Form ADV-C would be confidential.

Disclosure to Investors. The Cybersecurity Proposal would require the disclosure of cybersecurity risks and incidents to investors and other market participants via an adviser's Form ADV Part 2A brochure. The new Item 20 to the brochure would require advisers to describe cybersecurity risks that could materially affect advisory services and the ways in which the advisers assess, prioritize, and address those risks. This disclosure would also include any significant cybersecurity incidents that occurred within the previous two fiscal years. Advisers would be required to promptly deliver interim brochure amendments to existing clients if the adviser either (a) adds disclosure of a cybersecurity incident to its brochure or (b) materially revises information already disclosed in its brochure about a cybersecurity incident.

Annual Reviews, Recordkeeping and Exam Preparation

The PE Proposal would amend the Compliance Rule to require all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing. For each new proposed rule, the PE Proposal and the Cybersecurity Proposal also make corresponding extensions to the books and records requirements. Both changes, when paired with the Form PF Proposal, continue the trend by this SEC towards proscriptive approach dominated by forms, defined methodology and templates that seemed aimed at assisting staff in examinations and investigations as they continue to crack down on the private fund industry.

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