

Regulatory Alert

Regulatory Insights for Financial Services

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Private Funds: Proposals to enhance investor protections

The SEC proposed a two-part package of new rules and rule amendments under the Investment Advisers Act of 1940 that will require reforms in the private fund industry and amendments to the compliance rule under the Advisers Act for all registered advisers, including those that do not manage private funds. The proposed amendments are significant and have the ability to alter regulatory reporting, investor reporting, attestation, operations and fund structuring. Notably, the amendments would increase investors' ability to monitor the performance of their fund investments, including compensation, fees, and expenses, and to more easily make comparisons between prospective investments. All SEC registered advisers, and those required to be registered, must assess the operational impacts and associated controls from these potential changes. All financial services companies should expect increased regulatory focus in the private funds sector.

The SEC [proposed](#) new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act) in an effort to protect private fund investors and promote increased transparency, competition, and efficiency within the private fund market.

In particular, the proposed rules would require registered private fund advisers, or advisers that are required to be registered, to:

- Prepare quarterly statements pertaining to fees, expenses, and performance for any private fund that they advise and distribute the quarterly statement to the private fund's investors within 45 days after each calendar quarter end. As part of the quarterly statement:
 - Disclosures would be required to be presented at the private fund-level and the portfolio investment level (defined as any entity or issuer in which the private fund has invested directly or indirectly).
 - Fees and expenses would include all compensation paid during the reporting period to the private fund adviser and "related persons" (as defined in the rule to include (i) all officers, partners, or directors 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).
- Performance information would be presented in a standardized format where: liquid fund performance would be based on net total return on an annual basis since the fund's inception, over prescribed time periods, and on a quarterly basis for the current year; and illiquid fund performance would be shown based on the internal rate of return and a multiple of invested capital. Liquid and illiquid funds would be defined in the rule.
- Obtain an annual independent financial statement audit of each private fund they advise and "promptly" distribute the audited financial statements to investors. (SEC notes that although it has not proposed a specific timeframe, 120 days after a private fund's fiscal year end is generally considered to be appropriate.)
- Obtain a fairness opinion in connection with certain 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 rule would prohibit an adviser from completing an adviser-led secondary transaction unless the adviser, prior to the closing of the transaction, distributes to investors in the private fund a fairness opinion from an independent opinion provider and a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider.

Additionally, the proposed rules include prohibitions against certain activities by all private fund advisers, including those that are not registered with the SEC:

- Engaging in certain sales practices, conflicts of interest, and compensation schemes that are “contrary to the public interest and the protection of investors,” including:
 - Seeking reimbursement, indemnification, exculpation, or limitation of liability for certain activities, such as breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.
 - Charging certain fees and expenses to a private fund or its portfolio investments, such as fees for unperformed services (e.g., accelerated monitoring); fees or expenses associated with an examination or investigation of the adviser by a governmental or regulatory authority; regulatory or compliance expenses or fees of the adviser or its related persons; or fees and expenses related to certain portfolio investments on a non-pro rata basis.
 - Reducing the amount of an adviser clawback by the amount of certain taxes.
 - Borrowing or receiving any extension of credit, directly or indirectly, from a private fund client.
- Providing preferential treatment, including preferential terms to certain investors regarding redemption or

information about portfolio holdings or exposures, or any other preferential treatment to any investor in a private fund unless the adviser discloses such treatment to other current and prospective investors. “Preferential” terms would be dependent on facts and circumstances.

The SEC also proposed amendments to the Advisers Act Books and Records Rule and Compliance Rule, that would require:

- Advisers to private funds to retain books and records related to the proposed rule including requirements for the quarterly statement, annual audit, adviser-led secondary transactions, and preferential treatment.
- All advisers registered or required to be registered under Section 203 of the Advisers Act, including those that do not manage private funds, to at least annually review and document in writing the adequacy of their compliance policies and procedures and the effectiveness of their implementation.

In November 2021, the SEC [addressed](#) the impact that private fund advisors have on the economy and the increased necessity for transparency, competition, and efficiency around private funds. Fees and expenses, side letters, performance metrics, fiduciary duties, and conflicts of interest were specifically called out. Most recently the SEC released proposed amendments to Form PF and a Risk Alert from the Division of Examinations outlining compliance issues observed in examinations of registered investment advisers that manage private funds. (See KPMG Regulatory Alert, [here](#).)

The public comment period will remain open for 60 days following publication of the proposing release on the SEC’s website or 30 days following publication of the proposing release in the Federal Register, whichever period is longer.

For additional information, please contact [Larry Godin](#) or [Mark McKeever](#).

Contact the author:



Amy Matsuo
Principal and Leader
Regulatory and ESG Insights
amatsuo@kpmg.com

kpmg.com/socialmedia



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