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SEC Proposal Would Require Greater Private-Fund Disclosure

By **Tom Zanki**

Law360 (February 9, 2022, 3:32 PM EST) -- A divided U.S. Securities and Exchange Commission on Wednesday proposed rules seeking to increase disclosure and mitigate conflicts involving private funds, a move the majority said is needed to boost accountability in the vast world of private capital.

The proposal was one of two submitted for public comment Wednesday by the SEC, which also proposed requiring fund advisers to boost their cybersecurity preparedness.

The first proposal would amend Investment Advisers Act of 1940 rules by requiring that private fund advisers provide investors with quarterly disclosures detailing certain information about fund fees, expenses and performance. The proposal would also bar private fund advisers, including those not registered with the SEC, from providing certain preferential treatment to select investors unless that information is disclosed to all current and prospective investors.

The SEC normally focuses its investor protection efforts on retail investors who trade publicly registered securities. Given the vast growth of private investments, a market the SEC estimates at $18 trillion, Chair Gary Gensler said more transparency is needed.

Gensler noted that college endowments and pensions are deeply invested in private funds, which are often managed by hedge funds and private equity and venture capital firms. Those entities, in turn, often deploy that money into private companies.

"The people behind those pension funds and endowments often are teachers, firefighters, municipal workers, students and professors," Gensler said. "And who are the people on the other side of the private funds? They're entrepreneurs, trying to turn big ideas into big companies."

The 341-page proposal, which now goes out for public comment, was put forth by a 3-1 vote. Republican Commissioner Hester Peirce dissented, saying the SEC's proposal represents a "sea change" in its mission. Peirce questioned whether professional investors need the protections that securities laws typically grant to nonprofessionals.

"These well-heeled, well-represented investors are able to fend for themselves, and our resources are better spent on retail investor protection," Peirce said.

The SEC's effort is also sparking pushback from private funds, including the Managed Funds Association, a Washington, D.C.-based trade group that represents hedge funds.

"The SEC's proposed additional regulations on private funds will harm the most sophisticated investors, including pensions, endowments and foundations, who rely on these funds to serve their beneficiaries," Managed Funds Association CEO Bryan Corbett said in a statement. "The agency's treatment of private funds as if they were serving retail investors is misguided."

Members of the SEC's three-member majority, all Democrats, said the proposal ensures a level playing field for all private investors, which they said is now missing.

Commissioner Allison Herren Lee noted that the proposal would ban a private adviser from granting preferential redemption terms to one investor or a subset of investors — a practice she said can lead to significant dilution for those without the preference.

"Preferential treatment coupled with a lack of transparency can severely inhibit a party's bargaining ability and power, essentially leaving investors to bargain in the dark," Lee said.

The SEC's proposal additionally would require private fund advisers to obtain an annual audit for each private fund, and that auditor would have to notify the SEC of certain events. The agency also wants all registered investment advisers, including those that don't advise private funds, to document the annual review of their compliance policies in writing.

The investor watchdog has said before that private funds sometimes fail to follow fee practices in their disclosures or that they mislead their investors on performance. William Birdthistle, who directs the SEC's Investment Management Division, said Wednesday's proposal does not call on private funds to publicly disclose their holdings or strategies, but to reveal more information directly to investors.

"Despite our examination and enforcement efforts, private fund investors do not receive sufficient transparency regarding the full cost of investing in private funds, the performance of some private funds and conflicts of interest," Birdthistle said.

One attorney said the SEC appears to be moving beyond a "principles-based" approach that relies on broad guidelines, toward more detailed and prescriptive rules in how it oversees private funds.

"Many, if not most, of those investors are well represented and able to negotiate for the type and frequency of disclosure that they view as meaningful and useful," said Kelley Howes, a vice chair at Morrison & Foerster LLP's investment management group. "It is not clear that mandating specific quarterly disclosure will help such investors understand or evaluate their investments."

The SEC's latest proposal is one of several ongoing efforts to increase transparency in private investments. The agency last month proposed new disclosures, including requiring that hedge funds and private equity funds report within one business day unusual events that could disturb markets.

Separately, the SEC on Wednesday proposed rules requiring investment advisers to beef up their cybersecurity preparedness. The 243-page proposal would require, among other things, advisers and funds to adopt written cybersecurity policies and report significant cybersecurity breaches directly to the SEC on a confidential form.

Advisers and funds would also have to publicly disclose significant cybersecurity incidents that occurred within their last two fiscal years on their brochures and registration statements. The SEC's majority said the proposal would protect fund clients and the broader marketplace from cybersecurity risks.

"The proposal takes a much-needed holistic approach to the issue rather than the more discrete and piecemeal approach we've taken thus far," said Lee, who voted for the proposal.

The SEC agreed to release the cybersecurity proposal for comment by a 3-1 vote, with Peirce dissenting. She questioned the commission's authority to propose the rule.

"While having good cyber policies is important, there's no apparent logical connection between the effectiveness of an adviser's cyber policies and the soundness of its investment advice," Peirce said.

Public comment on both proposals will remain open for 60 days from when they are posted on the SEC's website, or 30 days from when they are published in the Federal Register, whichever period is longer.

--Editing by Kristen Becker