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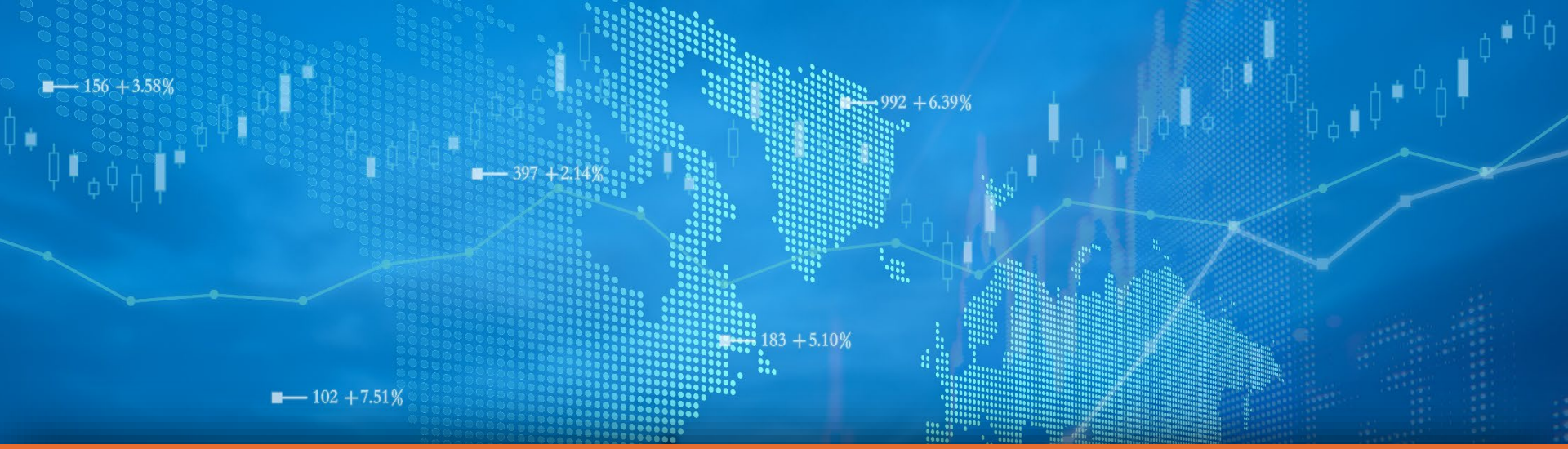
The SEC's Rulemaking Agenda: Bracing for New Rules

Ruth E. Delaney, *Partner*, K&L Gates LLP
Matthew Mangan, *Partner*, K&L Gates LLP
Keri E. Riemer, *Of Counsel*, K&L Gates LLP



The Rulemaking Agenda: What's the Big Picture?

RULEMAKING IN CONTEXT

"Why do [private funds] matter? First, they matter because they're large, and they're growing in size, complexity, and number.

More than those figures though, these funds matter because of what, or who, stands on either side of them."

SEC Chair Gary Gensler, *Prepared Remarks at the Institutional Limited Partners Association Summit*, November 10, 2021

"The Securities and Exchange Commission's job is to make markets work. But today's SEC leadership—which as of August had proposed 26 new rules this year alone—is ignoring the real-world effects of its regulations on market participants."

Eric Pan, President and CEO of the Investment Company Institute, *Wall Street Journal* Editorial, November 1, 2022

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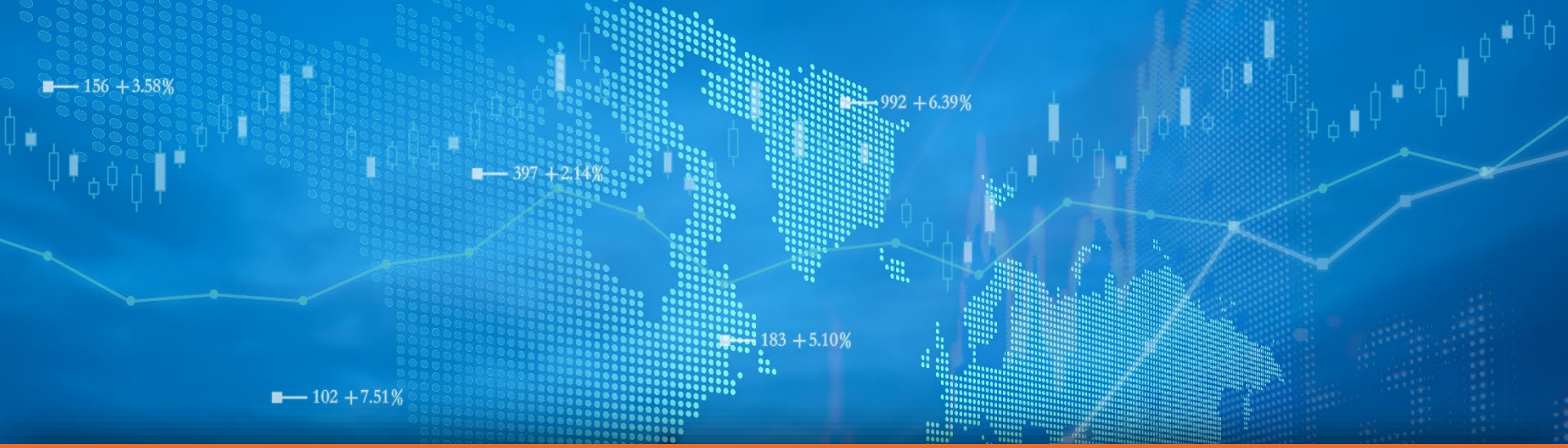
THIS SESSION WILL COVER

- Proposed Regulations
  - Private Fund Regulation
  - Form PF
  - Cybersecurity
  - ESG Rule
  - Service Provider Oversight
- The New Marketing Rule



Proposed Private Fund Adviser Rules

STATED PURPOSES FOR PROPOSAL

- Proposed on February 9, 2022
- Prohibit particular practices that SEC believes present conflicts of interest that cannot be solved by any level of disclosure (and resulting informed consent).
- Provide investors greater transparency.
- Correct perceived asymmetry of bargaining power between advisers and investors (even large, sophisticated investors) and between smaller and larger investors.

PROHIBITED ACTIVITIES

- Currently, private fund advisers can address most conflicts through **full and fair disclosure** of, and **informed consent** to, the conflict

- Proposed rule would **flatly prohibit** certain perceived conflicts of interest regardless of adviser's registration status or sophistication of investor counterparties

EXAMPLES OF PROHIBITED ACTIVITIES

- No preferential liquidity **and information** terms via side letter; required notice to other investors **and potential investors** of "other preferential terms"
- No exculpation for adviser's failure to meet **negligence** standard of care in providing services to a private fund (as opposed to typical gross negligence)
- No non-pro rata expense allocations for "broken deals." Must allocate expenses to parties who are not fund investors and never invest in a deal
- Cannot charge private funds for advisers' regulatory and compliance fees and expenses (including those associated with examination or investigation)
- No charging for underperformed/unperformed services

INVESTOR TRANSPARENCY

- Requires **registered** advisers to (i) provide quarterly statement to private fund investors with detailed accounting of both **fund-** and **portfolio company-level** information, and (ii) obtain an annual audit of each private fund by an independent public accountant subject to PCAOB oversight

- Stated purpose to **reduce** investor expense and burden associated with monitoring expenses, performance, and conflicting arrangements, and **improve** investors' ability to negotiate fund terms and compare services provided by advisers and other service providers

- Although requirements are generally (but not wholly) consistent with typical existing practice and rules, mandated timelines are tighter, more detail is required, and fewer exceptions are permitted than in existing regimes

MORE ON TRANSPARENCY

- Quarterly reports must present performance information using SEC-mandated calculations (without regard for leverage provided through subscription facilities), with prominent disclosure of criteria used and assumptions made when calculating performance

- Subadvisers must take “all reasonable steps” to require compliance with audit requirement for each private fund they subadvise, even if the private fund is controlled by an unaffiliated adviser and the subadviser does not have custody of the private fund’s investments

- Private fund’s auditor must notify the SEC if the auditor is terminated or modifies its audit opinion

ADVISER-LED SECONDARIES

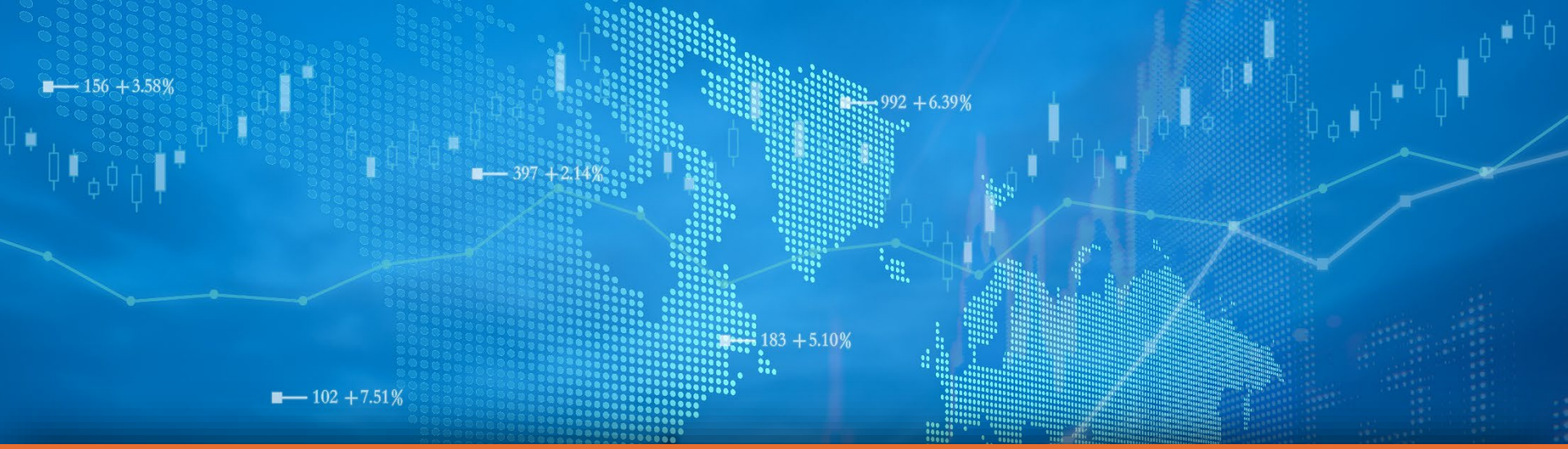
- For certain adviser-led secondary transactions, registered advisers must obtain and distribute prior to close (i) a fairness opinion provided by a third-party opinion provider and (ii) a summary of the material business relationships between opinion provider and adviser or related persons.

- Covers transactions that the private fund adviser or its related persons initiate and that offer investors the option either to sell their interests or to convert or exchange their interests for interests in another vehicle that the private fund adviser or its related persons advise.

- Provider of fairness opinion must be unrelated third party that provides such opinions in the ordinary course of business.

LIKELY EFFECTS OF PROPOSED RULES

- Greatly expanded regulatory compliance obligations for advisers to private funds
  - Certain key aspects of the rules apply to all private fund advisers, including non-registered advisers (e.g. ERAs)
- Extensions of types of protections formerly reserved to retail investors in public vehicles to sophisticated investors in private vehicles
- May require substantial revision of existing documentation as well as changes to future funds



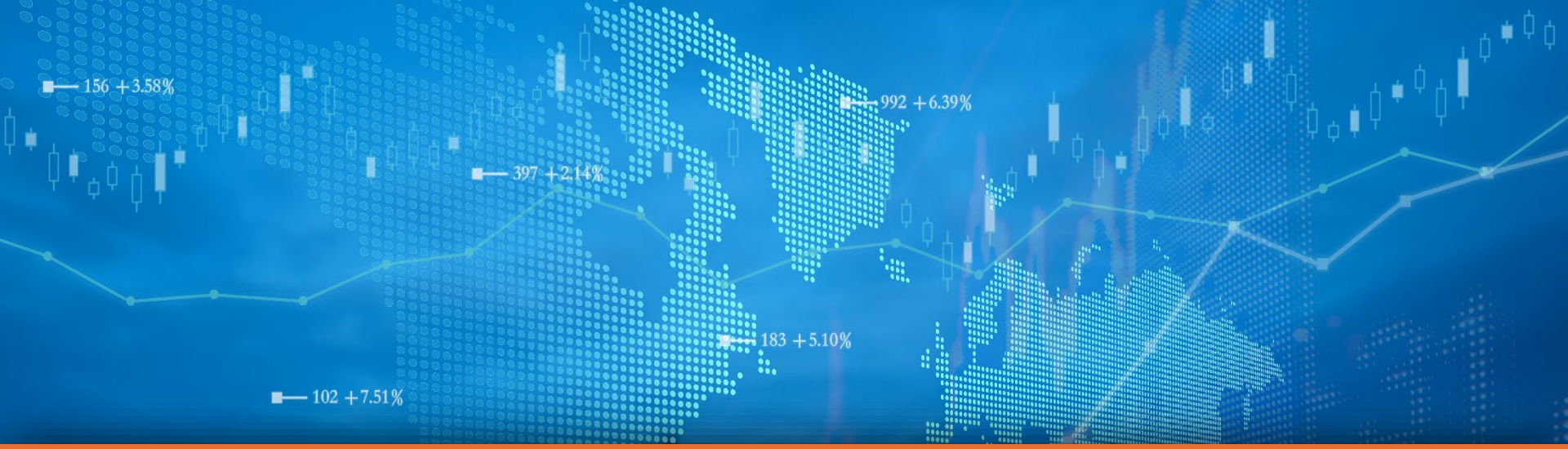
Proposed Amendments to Form PF

AMENDMENTS TO FORM PF

- On 26 January 2022, Proposed January 26, 2022
  - The SEC proposed amendments to Form PF, the confidential reporting form required to be filed by certain advisers to private funds.
- Key aspects of the proposal
  - Require large hedge fund advisers and private equity advisers to file current reports within one business day of the occurrence of certain significant events.
  - Expand reporting obligations for large private equity advisers and large liquidity fund advisers.
- Reflective of a broader effort by the SEC to increase transparency and oversight in the private fund industry.

ADDITIONAL AMENDMENTS TO FORM PF

- Proposed August 10, 2022
  - The additional amendments to Form PF, proposed by the SEC and CFTC, supplements portions of Form PF proposed by the SEC in January 2022.
- Key aspects of the proposal
  - Require private fund advisers to report more granular information regarding a reporting fund's investment strategies, counterparty exposure, operations, assets, financing, investor concentration, and performance, among other things.
  - Taken together, the proposed amendments would represent a significant shift in the depth of information required to be reported by private fund advisers on Form PF, as well as the timeline for reporting such information.
- Public comment period for the August proposal expired on October 11, 2022
  - Although the SEC recently reopened the comment periods for several other recent rule proposals, it did not reopen or extend comment periods for its Form PF proposals, despite requests from a number of prominent trade associations to grant an extension.



Cybersecurity Risk Management

PROPOSED CYBERSECURITY RISK MANAGEMENT REQUIREMENTS

- **Policies and Procedures.** Adopt and implement written policies and procedures reasonably designed to address cybersecurity risks
  - Policies and procedures must provide for, among other things:
    - Risk assessment – "Periodic" assessment and documentation of risks associated with adviser's information systems and potential impact of cybersecurity event
    - User Security and Access – Implement controls designed to minimize user-related risks and prevent unauthorized access
    - Information Protection – Monitor systems and protect information from unauthorized access or use
    - Threat and Vulnerability Management – Detect, mitigate and remediate any cybersecurity threat or vulnerability
    - Incident Response and Recovery – Adopt measures to detect and respond to a cybersecurity incident and document any such incident and response thereto
    - Annual Reviews and Written Reports
  - Role of service providers

PROPOSED CYBERSECURITY RISK MANAGEMENT REQUIREMENTS

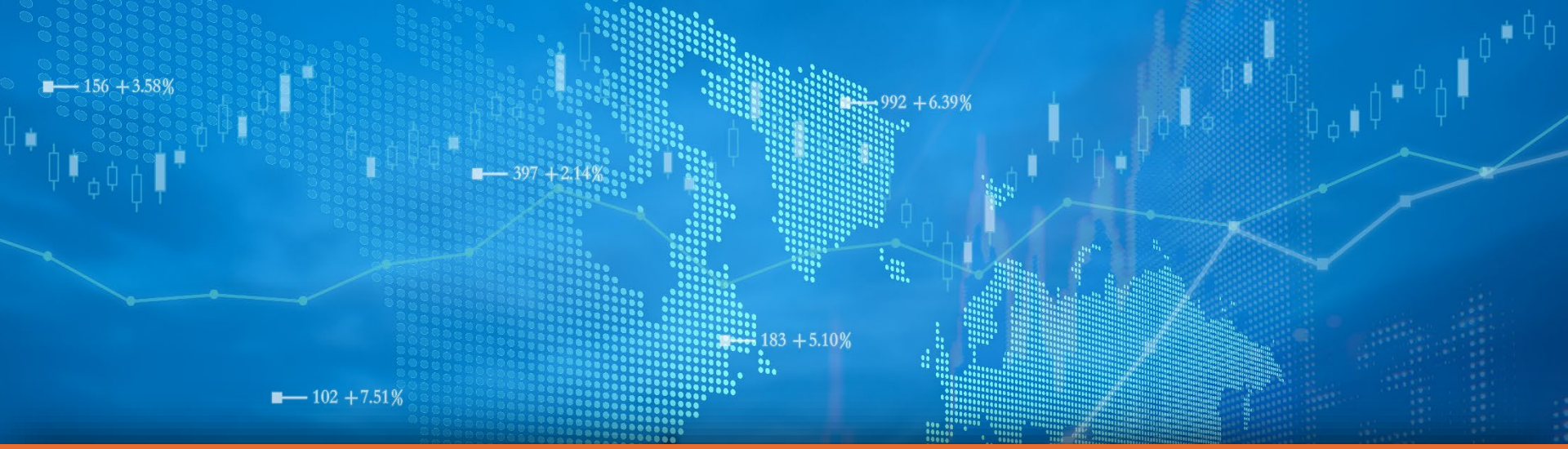
- **Reporting.** Must report "significant cybersecurity incident" to the SEC on new Form ADV-C *within 48 hours*
  - Incident that significantly disrupts or degrades the ability to maintain critical operations, or leads to the unauthorized access or use of information where such access or use results in "substantial harm"
  - Incident affecting the adviser, or a client that is a registered investment company, business development company or private fund
  - 48 hours after having a reasonable basis to conclude that an incident has occurred or is occurring -- not after definitively concluding that an incident has occurred or is occurring
  - Must also amend any previously filed Form ADV-C *within 48 hours* after information previously reported becomes materially inaccurate, if new material information about a reported incident is discovered, or after resolving a reported incident or closing an internal investigation pertaining to such a reported incident.

PROPOSED CYBERSECURITY RISK MANAGEMENT REQUIREMENTS

- **Disclosure.**
  - Must disclose in Form ADV Part 2A (brochure):
    - Cybersecurity risks that could materially affect the adviser's services
    - Cybersecurity incidents that occurred in last 2 fiscal years that significantly disrupted or degraded adviser's ability to maintain critical operations or that led to unauthorized access or use of adviser information, resulting in "substantial harm" to adviser or clients
  - Must *deliver* to existing clients interim amendment "promptly" if adviser adds disclosure of a cybersecurity incident or materially revises information previously disclosed
- **Recordkeeping requirements.** Must maintain records documenting occurrence of "any" cybersecurity incident that occurred in the last 5 years

CONSIDERATIONS AND POTENTIAL CHALLENGES TO ADVISERS

- Increased risk of enforcement action, regardless of efforts to thwart cyber attacks and adopt comprehensive cybersecurity programs to address and mitigate risks.
- Role of service providers.
- Impact on existing compliance policies and procedures
- Unclear if Form ADV-C – which would include sensitive data about an adviser's vulnerabilities – will be kept confidential.
- Adviser's focus and priorities during the first 48 hours and potential harm to clients.



Proposed ESG Reforms for Advisers

PROPOSED ESG REFORMS FOR ADVISERS

- Introduces new classification for investment strategies, with different disclosure and reporting requirements for each.
- Form ADV Part 1A reporting requirements would apply to registered *and unregistered* advisers.
- Form ADV Part 2A (brochure) disclosure requirements would include detailed disclosures for each significant investment strategy or method of analysis that includes consideration of at least one ESG factor.

PROPOSED ESG REFORMS FOR ADVISERS

- Proposed classification for investment strategies:
  - **Integration** – At least *one* ESG factor is "*considered*" alongside non-ESG factors in the adviser's investment decision making process, but such ESG factors are generally no more significant than others and may not be determinative with respect to any particular investment decision
  - **ESG Focused** – ESG factors are a "significant or main" consideration in advising clients with respect to investments, or in the adviser's engagement strategy
  - **ESG Impact** – ESG focused strategy that seeks to achieve at least one specific ESG impact

PROPOSED ESG REFORMS FOR ADVISERS

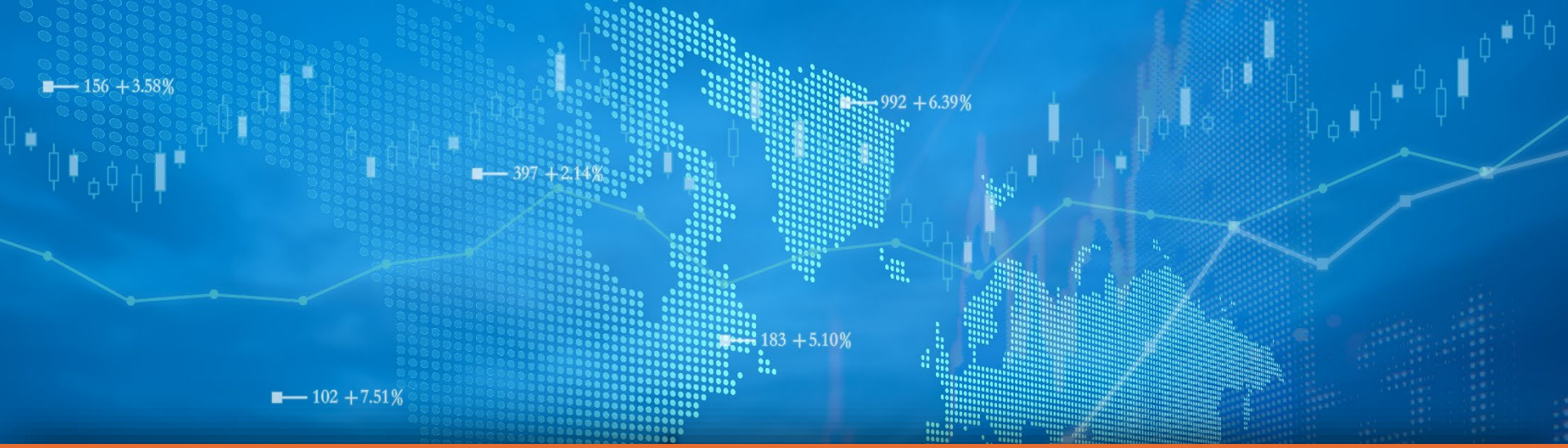
- Form ADV Part 1A requirements would include:
  - Reporting any ESG-related advisory services provided to separately managed account (SMA) clients and reported private funds in a check-the-box ("Yes" or "No") format
  - Adviser would need to identify if it uses an integration, ESG-focused or ESG impact strategy in providing services to its SMA or private fund clients, and which factor(s) it considers
  - Intended to capture information separately for each private fund and in the aggregate for all SMA clients
  - Report the name of any third-party ESG framework the adviser follows, and whether the adviser or any of its related persons is an ESG consultant or other ESG service provider
- Publicly available

PROPOSED ESG REFORMS FOR ADVISERS

- New brochure disclosures would include:
  - Detailed description of significant investment strategies or methods of analysis for which an adviser considers any ESG factor when providing investment advice
  - Explanation as to whether the strategy is integration, ESG focused or ESG impact
  - Description of any voting policies and procedures that include any ESG considerations, and any material arrangement with a related person ESG consultant or ESG service provider

CHALLENGES FOR ADVISERS

- Potential challenges of the proposed reforms include:
  - Overly broad definitions would likely impose reporting and disclosure requirements on most, if not all, advisers
  - Advisers would be required to make disclosures about an ESG factor regardless of its materiality
  - Elevating the role of ESG factors with enhanced disclosure requirements could further the appearance of “greenwashing” by overemphasizing their importance
  - Private fund advisers could be required to share strategy information in publicly available documents
    - Historically, information about strategies or trading methodologies has been disclosed confidentially on Form PF
  - Advisers would need to make subjective judgments, thereby exposing them to second guessing and potential challenges by SEC staff
  - Aggressive compliance deadline



Service Provider Oversight

SERVICE PROVIDER OVERSIGHT

- Proposed on October 26, 2022
- Key aspects of proposal
  - **Outsourcing "Covered Functions"** Proposed Rule 206(4)-11 would prohibit SEC-registered investment advisers from outsourcing certain "covered functions" to service providers unless certain requirements are met.
  - **Definition of "Covered Functions"** Functions or services that:
    - Are necessary to provide advisory services in compliance with the federal securities laws; and
    - If not performed or performed negligently, would reasonably be likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services.

SERVICE PROVIDER OVERSIGHT

- Key aspects of proposal, continued
  - **Due Diligence**. Before retaining a service provider to perform a "covered function," reasonably identify and determine through due diligence that outsourcing would be appropriate.
  - **Monitoring**. Adviser would be required to monitor performance and reassess the selection of the service provider. Adviser would also be required to create and maintain books and records relating to its due diligence and monitoring activities.
  - **Oversight of Third Party Recordkeepers**. Advisers that rely on third-party recordkeepers must conduct due diligence and monitoring of that third party as if the third party were a "service provider" performing a "covered function" as defined by the proposed rule.

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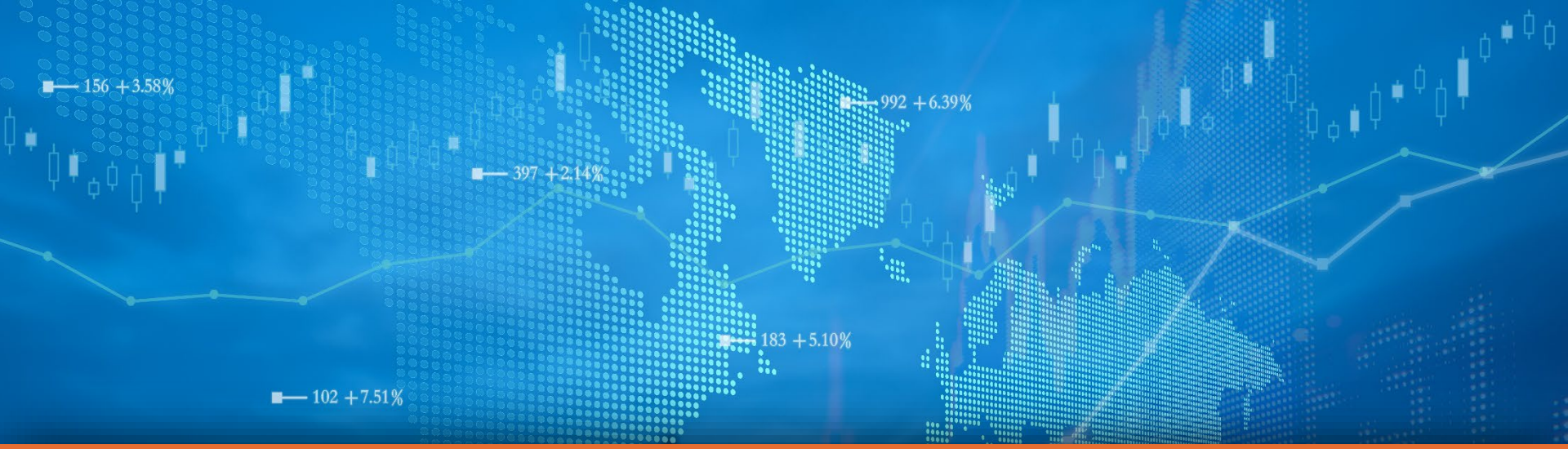
SERVICE PROVIDER OVERSIGHT

Covered Functions	Not Covered Functions
Engaging an index provider for purposes of developing an investment strategy for the adviser's clients.	Licensing a widely available index from an index provider to use as a performance hurdle.
Outsourcing compliance functions, including its chief compliance officer, and regulatory filings.	Functions performed by marketers and solicitors.
Valuation and pricing services to assist in fair-value determinations.	Common market data providers providing publicly available information.
Engaging an index provider to create or lease an index for the adviser to follow as a strategy for its advisory clients.	Purchasing a license to utilize a commonly available index solely as a comparison benchmark for performance and not to inform the adviser's investment decisions.
Technology integral to investment decision-making process, such as artificial intelligence.	Licensing of general software providers of widely commercially available operating systems.
Providing orders to a broker-dealer and allocating securities to client accounts after trades are made.	Lease of commercial office space or equipment.
Identifying which portfolios to include in or exclude from a transaction.	Use of public utility companies, or utility or facility maintenance services.

SERVICE PROVIDER OVERSIGHT

- Potential challenges to advisers
  - Vague definition of “covered function”
    - Legal counsel during fund launch?
    - Proxy or other consulting service?
    - Opportunities for second guessing
  - Subadvisers, affiliated service providers not excluded
  - Index providers
  - Many service providers already subject to SEC or FINRA
  - Sufficient transparency
  - Resources



The Marketing Rule

THE MARKETING RULE

- Proposed on December 22, 2020; **Effective Date: November 4, 2022**
- The new "Marketing Rule" under the Investment Advisers Act of 1940 (the "Advisers Act") creates a single rule that replaces:
  - Rule 206(4)-3 under the Advisers Rule (the "Solicitation Rule"); and
  - Rule 206(4)-1 under the Advisers Act (the "Advertising Rule")
- The Marketing Rule represents the first substantive amendments to the Solicitation Rule since its adoption in 1979.
- In connection with the implementation of the Marketing Rule, the SEC withdrew dozens of no-action letters interpreting the existing Solicitation and Advertising Rules.

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MARKETING RULE TIMELINE

November 4, 2019
Initial Rule Proposal

December 22, 2020
SEC Adoption

March 5, 2021
Publication in Federal Register

May 4, 2021
Effective Date

November 4, 2022
Compliance Date

Exactly 36 months from proposal to adoption

THE MARKETING RULE

- **The Marketing Rule extends to all "private funds."**
- The Rule establishes standardized, rule-based framework for performance advertising.
- Explicitly addresses performance portability and extracted performance.
- Replaces *per se* prohibitions with principles-based standards.
- Expressly permits past specific recommendations, testimonials, and third-party ratings.
- Guidance on social media, layered disclosures.

MARKETING RULE IMPLEMENTATION PROCESS

September 2022 Alert:

"The staff will conduct a number of specific national initiatives, as well as a ***broad review through the examination process*** for compliance with the Marketing Rule" that will include, but will not be limited to, the following areas:

- Marketing Rule Policies and Procedures
- Substantiation Requirement
- Performance Advertising Requirements
- Books and Records

"The Division encourages advisers to … implement any appropriate modifications to their **training**, **supervisory**, **oversight**, and **compliance programs**."