Simpson Thacher

Regulatory and Enforcement Alert

"Transparency Is Not Enough"—SEC Continues Steady March Towards More Intrusive Regulation of Private Funds

February 9, 2022

In a split 3-1 vote earlier today, the SEC proposed sweeping new rules targeted at private equity and other private funds.[1] The proposal, if adopted, would essentially change commercially negotiated terms, in particular the negotiated indemnification provision, by substantive regulation. It also would significantly expand the disclosure of standardized fee and expense information and broadly prohibit certain practices in the private funds industry. The proposed rules assume a bleak view of the conduct and business practices of private fund managers, as well as a view that private fund investors, generally some of the most sophisticated and well-represented investors in the world, are insufficiently prepared to protect their commercial interests. For example, and in an abrupt departure from longstanding, negotiated market practice, the proposed rules would prohibit, by regulation, a fund manager being indemnified in cases of ordinary negligence. Such a term has been commercially negotiated for decades, and questions are sure to emerge about whether such a prohibition exceeds the SEC's authority and whether the SEC has provided a sufficient economic justification for that type of intrusive prohibition.

Taken together with the Commission's recent proposed amendments to Form PF,[2] which would mandate confidential reporting of a wide range of ordinary course fund and portfolio company activity under the guise of monitoring systemic risk, today's rule proposals suggest that the regulator is seeking fundamental changes in the manner it regulates the private funds industry. Commissioner Peirce in her dissent characterized the proposed rules as a "sea change."[3]

In addition to the changes described above, as well as several more administrative proposals, today's proposed rules would also:

- Mandate that investors be provided—in connection with an adviser-led secondary transaction—a fairness

[1] The SEC has published the full text of the proposal: *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews* as well as a *Private Fund Proposed Reforms Fact Sheet*. At the same meeting, the SEC proposed new rules requiring certain investment advisers and investment companies to adopt cybersecurity risk management programs. *See Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies* and a *Cybersecurity Risk Management Fact Sheet*.
[2] For more on this, *see* Simpson Thacher, *SEC Proposes Changes to Form PF That Could Prove Challenging*.
[3] SEC Commissioner Hester M. Peirce, *Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking*.

opinion and a written summary of certain material business relationships between the adviser and the opinion provider;

- Prohibit advisers from reducing the amount of any clawback by the amount of certain “actual, potential or hypothetical” taxes;
- Prohibit the payment of fees for services that have not yet been performed (*e.g.*, accelerated monitoring fees); and
- Prohibit, via the negotiation of side letters, advisers from providing perceived preferential treatment to certain investors unless disclosed to current and prospective investors.

Conclusion

The Commission has painted a purposefully bleak assessment of the state of the private funds industry to make the case for its proposed regulatory overhaul. Indeed, some of the proposals address supposedly widespread problems that appear to us to be overblown or are issues from a bygone era—for example, the practice of taking fees for unperformed services, such as accelerated monitoring fees. Likewise, fund investors today, as a general matter, negotiate for and receive regular reporting of fee, expense and performance information. Further, general fiduciary principles already prohibit a wide array of self-dealing portrayed by the Commission as endemic in the industry. In this regard, many of today’s proposals are unlikely to meaningfully affect many advisers who have never participated in these practices or have already moved away from them and have adopted best practices regarding disclosure and reporting. In other instances, however, the Commission appears willing to overturn by regulation the well-established and negotiated practice of contractually permitting a fund manager to be indemnified in instances of mere negligence.

We anticipate significant industry pushback on the breadth and scope of the new proposed rules during the comment period, which will be the longer of 60 days after today or 30 days after publication of the proposal in the Federal Register. We also anticipate intense interest in, and scrutiny of, the SEC’s economic analysis for its proposals, including whether they rest solely on generalized assumptions that the rules will simply enhance market efficiency. Should the rules eventually be enacted in their current form, significant litigation challenges could well follow.

For further information regarding this Alert, please contact one of the following authors:

WASHINGTON, D.C.

David W. Blass
+1-202-636-5863
david.blass@stblaw.com

Meaghan A. Kelly
+1-202-636-5542
mkelly@stblaw.com

NEW YORK CITY

Marc P. Berger
+1-212-455-2197
marc.berger@stblaw.com

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Michael W. Wolitzer
+1-212-455-7440
mwolitzer@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.