SEC Proposes Sweeping New Regulatory and Enforcement Regime for Private Funds and Private Market Participants

Over a two week period at the end of January and beginning of February, the U.S. Securities and Exchange Commission ("SEC" or "Commission") proposed new rules and rule amendments that presage sweeping regulatory and enforcement regime changes for private funds and private markets participants.

On February 9, 2022, the SEC voted 3-1 in favor of a set of proposed rules and amendments under the Investment Advisers Act of 1940 (the "Advisers Act") that, if adopted, would significantly increase the SEC's powers of oversight and enforcement in private markets (the "Proposed Adviser Rules").[1] The Proposed Adviser Rules are intended "to enhance the regulation of private fund advisers and to protect private fund investors by increasing transparency, competition, and efficiency in the $18-trillion [private fund] marketplace"[2]—which has been a particular point of emphasis for SEC Chair Gary Gensler since his appointment in April 2021.

On January 26, 2022, the SEC also voted 3-1 in favor of a set of proposed amendments to Form PF (the "Proposed Form PF Amendments"), which would change the reporting obligations of registered investment advisers to large hedge funds, private equity funds, liquidity funds, and venture capital funds,[3] by imposing new "current reporting" requirements and expanding the information required to be reported.[4] The Proposed Form PF Amendments would also dramatically expand the number of advisers subject to the "large private equity adviser" reporting requirements, by *decreasing* the threshold of assets under management ("AUM") for that designation from $2 billion to $1.5 billion.[5]

Together, the Proposed Adviser Rules and the Proposed Form PF Amendments evidence the Gensler Commission's laser focus on private markets participants and their advisers. Chair Gensler

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1 Press Release 2022-19, "SEC Proposed to Enhance Private Fund Investor Protection" (Feb. 9, 2022), *available at* https://www.sec.gov/news/press-release/2022-19; *see also* 17 CFR Part 275, Release No. IA-5955, "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Review" (Feb. 9, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-5955.pdf (hereinafter, "Proposed Adviser Rules").

2 Press Release 2022-19, "SEC Proposed to Enhance Private Fund Investor Protection" (Feb. 9, 2022), *available at* https://www.sec.gov/news/press-release/2022-19.

3 "Hedge funds," "private equity funds," and "venture capital funds" are technical terms previously defined by SEC rulemaking that do not line up in all cases with how those terms are commonly used in the market. For example, some private equity, venture capital, private credit and real estate funds are classified as "hedge funds" for Form PF purposes depending upon, among other attributes, their leverage and trading strategies. In addition, some newer strategies (such as funds investing in digital assets or litigation finance) may be classified as "hedge funds" or "private equity funds." Firms should review the classifications of their private funds as the reporting requirements for "hedge funds" and "private equity funds" continue to diverge. Further, although advisers who solely advise funds are exempt from Form PF reporting under SEC Rule 203, advisers who advise a mix of private funds, only some of which are required to file Form PF, will have to make disclosures as to all of their advisees.

4 *See* SEC Release No. IA-5950, Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, at 1 (Jan. 26, 2022) ("Proposed Form PF Amendments"), *available at* https://www.sec.gov/rules/proposed/2022/ia-5950.pdf; Fact Sheet, Proposed Amendments to Form PF, *available at* https://www.sec.gov/files/ia-5950-fact-sheet.pdf.

5 Proposed Form PF Amendments at 8.

has emphasized the need to "bolster the Commission's oversight of private fund advisers and the protection of investors in those funds."[6] The proposed rules are replete with references to investor protection and enforcement.[7] Statements such as these strongly suggest that the proposed rules may be an enforcement tool in sheep's clothing and a harbinger of SEC enforcement actions to come.

I. Proposed Amendments to Private Fund Investor Reporting and Documentation Under the Advisers Act

The Proposed Adviser Rules would add new and amended rules under the Advisers Act, which the SEC believes are necessary to increase transparency and avoid conflicts of interest. The proposed requirements mirror many of the requirements for public companies under the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") and the Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Dodd–Frank Act"), and represent an unprecedented level of SEC scrutiny and oversight of previously private markets. The Proposed Adviser Rules have the potential to significantly increase regulatory and enforcement risks for both registered and exempt advisers to private funds. Accordingly, the Proposed Adviser Rules likely represent the beginning of a more aggressive phase of SEC enforcement aimed at private funds.

In its notice of proposed rulemaking, the Commission acknowledged—if only tacitly—the magnitude of the changes reflected in the Proposed Adviser Rules, by providing for a one-year "transition period" for private funds to come into compliance.[8] The complexity of the transition notwithstanding, a majority of the Commission readily endorsed the Proposed Adviser Rules, with Commissioner Allison Herren Lee noting that the rules serve the goals of "[t]ransparency, protection against conflicts of interest, and accountability . . . cornerstones of investor protection in all markets for all investors."[9] The Commission justified the rules "[a]s a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business."[10]

A. SEC's Enhanced Monitoring of Private Markets and Private Funds

In 2015, then-SEC Chair Mary Jo White hinted at the potential for further regulation of private funds, remarking that "firm-specific risks and risks that may also affect . . . the financial system . . . are often intertwined, without clear distinctions."[11] Two administrations later, in May 2021, Chair Gensler

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[6] Chair Gary Gensler, Statement on Form PF (Jan. 26, 2022), *available at* https://www.sec.gov/news/statement/gensler-form-pf-20220126.

[7] Press Release 2022-19, "SEC Proposed to Enhance Private Fund Investor Protection" (Feb. 9, 2022), *available at* https://www.sec.gov/news/press-release/2022-19; Proposed Form PF Amendments at 87, 118, and 125; *see also id.*, Federal Information Law and Requirements for Collection of Information ("The SEC and CFTC may also use information collected on Form PF in their regulatory programs, including examinations, investigations and investor protection efforts relating to private fund advisers."); *id.* ("SEC may use Form PF information in an enforcement action.").

[8] Proposed Adviser Rules at 182-83.

[9] Commissioner Allison Herren Lee, "Statement on Proposed Rules for Private Fund Advisers" (Feb. 9, 2022), *available at* https://www.sec.gov/news/statement/lee-private-fund-20220209.

[10] *Id.*

[11] Former-Chair Mary Jo White, Keynote Address at the Managed Fund Association: "Five Years On: Regulation of Private Fund Advisers After Dodd-Frank" (Oct. 16, 2015), *available at* https://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html.
https://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html

observed that "[t]here is no self-regulatory organization for investment advisers" and that the SEC must "evolve" in response to the "growth and changes in private funds."[12] In November 2021, Chair Gensler again telegraphed a shift in the SEC's approach toward private funds, stating that "the sheer size and transaction activities of [private] funds"—some $17 trillion—demands "more granular" oversight of fund advisers.[13] And, in January of this year, Chair Gensler reiterated his belief that regulators should "use [their] authorities to bring greater transparency and competition into [the private funds] market, [to] help[] portfolio companies on the one hand, and the pensions and endowments that are investing in that space on the other.[14]

The SEC's Proposed Adviser Rules followed shortly thereafter. If enacted, the Proposed Adviser Rules would significantly expand the regulation of registered and exempt private fund advisers. The new regime includes:[15]

- **Quarterly Statement Rule:**[16] Advisers will be required to prepare and distribute quarterly statements to fund investors. Statements must include, for the preceding quarter: (i) all fees and expenses paid by the fund; (ii) adviser compensation; and (iii) fund performance.[17]

  According to the SEC, the Quarterly Statement Rule "is designed to improve the quality of information provided to fund investors and enable them to better assess, monitor, and compare their private fund investments."[18]

- **Private Fund Audit Rule:**[19] Advisers will be required to cause their funds to "undergo a financial statement audit at least annually and upon liquidation," conducted by an independent public accountant registered with the Public Company Accounting Oversight Board ("PCAOB"). The audited financial statements must be distributed to fund investors promptly after completion of the audit, and the independent accountant must notify the

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[12] Chair Gary Gensler, Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee (May 26, 2021), *available at* https://www.sec.gov/news/testimony/gensler-2021-05-26.

[13] Chair Gary Gensler, Prepared Remarks at the Institutional Limited Partners Association Summit (Nov. 10, 2021), *available at* https://www.sec.gov/news/speech/gensler-ilpa-20211110.

[14] Chair Gary Gensler, Prepared Remarks: "Dynamic Regulation for a Dynamic Society" Before the Exchequer Club of Washington, D.C." (Jan. 19, 2022), *available at* https://www.sec.gov/news/speech/gensler-dynamic-regulation-20220119.

[15] The Prohibited Activities Rule and Preferential Treatment Rule, described herein, would also apply to "all advisers to private funds (even if not registered), including some small entities." Proposed Adviser Rules at 312.

[16] Proposed SEC Rule § 275.211(h)(1)-2.

[17] Performance reporting metrics would differ depending on whether the fund in question was classified as "illiquid" or "liquid." The Proposed Adviser Rules define an "illiquid fund" as "a private fund that: (i) has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor's request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments." *See* Proposed Adviser Rules at 59. Advisers to illiquid funds, most commonly private equity funds and venture capital funds, will be required to report gross and net internal rate of return, as well as gross and net multiple of invested capital for the illiquid fund to capture performance from the fund's inception through the end of the current calendar quarter. *Id.* at 337. Liquid funds, defined as all private funds not categorized as illiquid, will be required to report annual net total returns since inception, average annual net total returns over prescribed time periods, and quarterly net total returns for the current calendar year. *Id.*

[18] *Id.* at 18.

[19] Proposed SEC Rule § 275.206(4)-10.

Commission that it has completed the audit or that it is no longer engaged to complete the audit.[20]

The SEC's professed purpose in adopting the Private Fund Audit Rule is to "provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees, and protect private fund investors against misappropriation of fund assets."[21]

- **Adviser-Led Secondaries Rule:**[22] In the event that an adviser or one of its related persons has a conflict of interest when offering existing fund investors the option to sell or exchange their interests in the fund for interests in another vehicle advised by the adviser or any of its related persons (an "adviser-led secondary transaction"), before closing such transaction. the adviser will be required to obtain and distribute to fund investors: (i) a fairness opinion from an independent opinion provider;[23] and (ii) a written 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.[24]

  With the Adviser-Led Secondaries Rule, the SEC aims to "provide a check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors."[25]

- **Prohibited Activities Rule:**[26] Private funds will no longer be allowed to engage, either directly or indirectly, in "certain activities and practices that are contrary to the public interest and the protection of investors."[27] The prohibited activities include:

  - Accelerated Payments: Charging a portfolio investment monitoring, servicing, consulting, or other fees with respect to any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment.[28]

  - Passthrough Fees and Expenses: 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.[29]

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20 Proposed Adviser Rules at 328-29.
21 *Id.* at 99.
22 Proposed SEC Rule § 275.211(h)(2)-2.
23 Under the Proposed Adviser Rules, an "independent opinion provider" is one who "(i) provides fairness opinions in the ordinary course of its business and (ii) is not a related person of the adviser." Proposed Adviser Rules at 125; *see also* Proposed SEC Rule § 211(h)(1)-1.
24 Proposed Adviser Rules at 125.
25 *Id.* at 122.
26 Proposed SEC Rule § 275.211(h)(2)-1.
27 Proposed Adviser Rules at 132.
28 *Id.* at 136.
29 *Id.* at 140. The Commission "believe[s] advisers should bear the compliance expenses related to their registration with the Commission, including fees and expenses related to preparing and filing all items and corresponding schedules in Form."

- Reducing Adviser Clawbacks: Including provisions in adviser agreements that allow an adviser to only return the post-tax portion of performance-based compensation found to be in excess of the adviser's appropriate compensation.[30]
- Limiting Adviser Liability: Including provisions in adviser agreements that allow the adviser to seek reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.[31]
- Non-Pro Rate Fee and Expense Allocation: Allocating fees and expenses related to a 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, in such a way that is prone to conflicts of interest.[32]
- Borrowing: Obtaining money, securities, or other fund assets, or receiving an extension of credit, from a private fund client.[33]

According to the SEC, the Prohibited Activities Rule is intended to curb "activities [that] incentivize advisers to place their interests ahead of their clients' (and, by extension, their investors'), and can result in private funds and their investors, particularly smaller investors that are not able to negotiate preferential deals with the adviser and its related persons, bearing an unfair proportion of fees and expenses."[34]

- **Preferential Treatment Rule:**[35] Advisers will be prohibited from providing preferential terms for fund redemptions or information about portfolio holdings or exposures to certain investors. Any other preferential treatment extended to certain investors must be disclosed to current and prospective investors.

  The Preferential Treatment Rule is intended to protect investors by prohibiting specific types of preferential treatment that have a material, negative effect on other investors.[36]

- **Books and Records Amendments:**[37] Advisers shall be subject to amended and expanded books and records requirements, including records related to quarterly statements, newly-required audits, and the advisers' bases for classifying the fund in question as either liquid or illiquid.

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30 *Id.* at 144.
31 *Id.* at 150.
32 *Id.* at 152-53.
33 *Id.* at 158.
34 *Id.* at 132.
35 Proposed SEC Rule § 275.211(h)(2)-3.
36 Proposed Adviser Rules at 162.
37 Proposed SEC Rule § 275.204-2.

The Books and Records Amendments are expressly designed to enable the SEC to assess an adviser's compliance with the Proposed Adviser Rules.[38]

- **Compliance Rule Amendments:**[39] Advisers, including those that do not advise private funds, will be required to document their annual reviews of their compliance policies and procedures in writing.[40]

B. A "Sea Change" for Private Markets Regulation and Enforcement?

Taken as a whole, the SEC's proposed amendments to the Advisers Act for exempt and registered private funds appear to be nothing less than a de-privatization of the private markets and a vast expansion of the SEC's regulatory and enforcement oversight. For that reason, the Commission's lone dissenter, Commissioner Hester Peirce, objected to the Proposed Adviser Rules as a "sea change" in private fund regulation that "represent[s] a meaningful recasting of the SEC's mission."[41] Commissioner Peirce raised three inter-related concerns:

First, the Proposed Adviser Rules constitute "a departure from the Commission's historical view" that the contemporary disclosure framework exists to protect retail investors, not sophisticated and accredited private funds investors, who are presumed able to "fend for themselves."[42] It has been the Commission orthodoxy—since at least the U.S. Supreme Court's landmark 1953 decision in *Securities & Exchange Commission v. Ralston Purina Co.*[43]—that institutional investors and high-net worth individuals who invest in private placements have sufficient negotiating power to "replicate regulatory protections privately through the contracting process and reliance on background antifraud standards."[44] Now, Commissioner Peirce warns, the Commission intends to extend "retail-like protections to accredited investors . . . publicly calling into question the rationale for dividing retail from accredited investors."[45]

Second, by extending the Commission's reach further into private markets, the new rules will necessarily shift limited examination and enforcement resources away from the public markets. If finalized, the Proposed Adviser Rules will require the SEC's Divisions of Examinations and Enforcement to spend more time and resources investigating the activities of private funds (whose investors have significant economic power), and less time on investigations most relevant to public-

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38 Proposed Adviser Rules at 326-27.
39 Proposed SEC Rule § 275.206(4)-7.
40 Proposed Adviser Rules at 178.
41 Commissioner Hester M. Peirce, "Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking" (Feb. 9, 2022), *available at* https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922.
42 *Id.*
43 346 U.S. 119 (1953).
44 Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 Colum. Bus. L. Rev. 1, 11 (1999). Consistent with that understanding, the Proposed Adviser Rules reemphasize the fact that adviser statements made pursuant to the new rules, such as those conveyed in their quarterly statements, will be subject to the anti-fraud provisions of the Federal securities laws. *See* Proposed Adviser Rules at 58 & n.68.
45 *See* Peirce, *supra*, note 41.

company and retail investors."[46] If this leads to fewer enforcement actions related to public company misconduct, it could undermine public confidence in capital markets.

Third, the proposed rules have the potential to undercut one of the chief policy rationales for applying a light regulatory touch to private funds: The relative ease of capital formation that occurs outside of regulatory oversight. A long-held assumption in the private fund space is that issuers that raise capital through private placements are "able to make efficient use of capital to build their business . . . due to . . . reduc[ing] the transaction cost involved in obtaining money from capital markets since the issuers can avoid costly regulation."[47] Although the actual value of such efficiencies may lag behind the hopes of accredited investors, a "sea change" in the market's perception of the potential of private placements, and a concomitant reduction in their valuations, are unavoidable consequences of announcing a brand new regulatory scheme applicable to these investment vehicles.[48]

C. Examination and Enforcement Risks of the New Regime

Although the Proposed Adviser Rules still need to go through a notice and comment period and provide for a one-year transitional period after enactment, over time, the Proposed Adviser Rules will give rise to significantly increased numbers of SEC examinations and resultant enforcement actions against private funds, hedge funds, venture capital funds and their advisers. The Proposed Adviser Rules provide the Commission with an array of new tools in its arsenal, justifying investigations and enforcement actions targeting private funds. Indeed, the Commission has expressly stated that it is promulgating the Proposed Adviser Rules to "help facilitate the Commission's enforcement and examination capabilities."[49] Accordingly, private markets participants should anticipate additional examination and enforcement as a result of the Proposed Adviser Rules.

As an initial matter, the Commission's increased focus on the conduct of private fund advisors may result in an uptick in the number of actions under the antifraud provisions of the Advisers Act. The SEC may elect to pursue—both more frequently and more aggressively—the types of fraud actions that it historically has brought against registered advisers for, *e.g.*, failures to disclose conflicts of interest with respect to recommended investments;[50] materially false and misleading marketing materials;[51] and failures to provide services for which the adviser in question has already accepted fees.[52]

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46 Darian M. Ibrahim, *Public or Private Venture Capital*, 94 WALR 1137, 1143 (Oct. 2019).

47 So-Yeon Lee, *Why the "Accredited Investor" Standard Fails the Average Investor*, 31 Rev. Banking & Fin. L. 987, 991 (2012).

48 *See* Peirce, *supra* note 41 (quoting then-Commissioner Troy Paredes' 2011 remarks regarding increased regulation of venture capital funds in which Commissioner Paredes expressed concern that "the Commission is shaping a regulatory regime that ultimately will come at the expense of capital formation, innovation, entrepreneurism, and jobs. As the VC fund industry is required to bear more regulatory burdens and demands, the risk is that capital formation will be unduly hindered.").

49 Proposed Adviser Rules at 97.

50 *See In the Matter of O.N. Investment Management Co.*, Admin Proceeding No. 3-20701 (Jan. 11, 2022) (failure to disclose that registered adviser's parent company would benefit indirectly if fund participants selected adviser's recommended investment strategy), *available at* https://www.sec.gov/litigation/admin/2022/ia-5944.pdf.

51 Press Release 2022-24, "SEC Charges Robo-Adviser with Misleading Clients" (Feb. 10. 2022) (robo-adviser touted its compliance measures to investors without ever adopting written policies and procedures conforming to its representations).

52 *See In the Matter of Regal Investment Advisors LLC, et al.*, Admin. Proceeding No. 3-20565 (Sept. 16, 2021) (adviser accepted advisory fees while advisors failed to monitors advisees' accounts to confirm that the portfolios were consistent with each advisee's investments goals).

Once the Proposed Adviser Rules are enacted, the SEC's first examination and enforcement efforts are likely to stem from alleged violations of the books and records and reporting obligations. As Chair Gensler observed last year, the SEC considers "recordkeeping and books-and-records obligations [to be] an essential part of market integrity and a foundational component of the SEC's ability to be an effective cop on the beat."[53]

In addition, the Proposed Adviser Rules—in many ways—hold private funds to the standards currently applicable to public issuers. It is therefore instructive to look to the types of enforcement actions recently brought by the SEC against public companies as exemplars of the types of enforcement actions that the Commission may bring under the Proposed Adviser Rules:

- **Books and Records and Documentation:** The expanded books and records and documentation obligations under the Proposed Adviser Rules are likely to give rise to enforcement actions and self-reporting initiatives where the SEC pursues initial failures to comply with new documentation requirements. For example, following the SEC's adoption of Form CRS, the Division of Enforcement brought actions against over two dozen financial firms for filing and delivery failures.[54] Similarly, the SEC has recently brought actions against broker-dealers for failure to institute robust document retention policies that preserve business-related text messages.[55]

- **Undisclosed Conflicts of Interest:** Investment advisers already are required to disclose conflicts of interest in certain circumstances, and failures to do so have been penalized by the Commission.[56] If finalized, similar obligations and enforcement risks will flow from the new disclosures that advisers make (or fail to make) to accredited investors. For example, the SEC previously has charged issuers for failing to disclose personal benefits conferred on company management.[57] Such actions are consistent with the policy prerogatives underlying the Prohibited Activities Rule.

- **Materially False and Misleading or Otherwise Deficient Quarterly Reports:** The SEC previously has fined public companies for failing to provide proper interim financial statements in quarterly reports.[58] The SEC also has brought more-nuanced antifraud

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[53] Press Release 2021-262, "JP Morgan Admits to Widespread Recordkeeping Failures and Agrees to Pay $125 Million Penalty to Resolve SEC Charges" (Dec. 17, 2021), *available at* https://www.sec.gov/news/press-release/2021-262.

[54] *See* Press Release 2021-139, "SEC Chargers 27 Financial Firms for Form CRS Filing and Delivery Failures" (July 26, 2021), *available at* https://www.sec.gov/news/press-release/2021-139.

[55] *See J.P. Morgan Securities, LLC*, Exchange Act Release No. 93807 (Dec. 17, 2021), *available at* https://www.sec.gov/news/press-release/2021-262 (imposing $125 million penalty for widespread failure to comply with recordkeeping requirements and devise adequate policies and procedures); *Jonestrading Institutional Servs. LLC*, Admin Proceeding No. 3-20050 (Sept. 23, 2020) (levying $100,000 fine against broker-dealer for failure to preserve text messages in violation of Exchange Act), *available at* https://www.sec.gov/litigation/admin/2020/34-89975.pdf.

[56] *See In the Matter of Verus Capital Partners*, Admin. Proceeding No. 3-20361 (June 7, 2021) (cease-and-desist order related to registered investment adviser's failure to disclose loans from related parties), *available at* https://www.sec.gov/litigation/admin/2021/ia-5748.pdf.

[57] Press Release 2020-242, "SEC Charges Hospitality Company for Failing to Disclose Executive Perks" (Sept. 30, 2020), *available at* https://www.sec.gov/news/press-release/2020-242.

[58] Press Release 2018-207, "Public Companies Charged with Failing to Comply With Quarterly Reporting Obligations" (Sept. 21, 2018), *available at* https://www.sec.gov/news/press-release/2018-207. Note that in the matters in question, the

actions in federal court for statements made in quarterly reports that, although "literally true," tended to "create a materially misleading impression."[59]

- **Fraudulent Audits:** Although many enforcement actions related to improper or fraudulent audits are directed against third-party accounting firms, the Commission has also charged an issuer and its executives for "creat[ing] false inventory lists and shipping documents to cover up a $1.39 million inventory shortfall," and for "provid[ing] the fabricated documents to its outside auditor," which caused the issuer's audited financial statements to overstate the company's income.[60] If the Private Fund Audit Rule is finalized, then the SEC will hold private funds to the same level of accuracy in reporting and cooperation with their auditors, and may bring analogous enforcement actions against private funds for any failures.

- **Inadequate Internal Controls:** The SEC has brought myriad settled and litigated actions against public companies under Section 13(b)(2)(B) of the Securities Exchange Act of 1934 for inadequate internal accounting controls. Moreover, in late 2020, the SEC indicated a willingness to expand its internal controls oversight beyond the strict accounting space. In *Andeavor LLC*,[61] the SEC brought a settled action against a publicly company for "us[ing] an abbreviated and informal process" to buy back stock from a shareholder without first having in place sufficient internal controls to ensure that the buyback was executed in accord with management's authorization and that the company was not in possession of material non-public information.[62] Private funds subject to additional compliance responsibilities under the Proposed Adviser Rules may want to look to this case as instructive of the SEC's approach to effective internal controls procedures and "good corporate hygiene."[63]

II. Proposed Amendments to Private Fund Current Reporting Requirements in Form PF

The SEC's Proposed Form PF Amendments[64]—the first in over ten years—are professed to fill "significant information gaps" and "provide the Commission and [the Financial Stability Oversight Council] with more timely information to analyze and assess risks to investors and the markets more

public companies' financial reports were improper because they had not been reviewed by an independent external auditor. Under the Proposed Adviser Rules, however, financial statements included in private funds' quarterly reports would not be subject to a similar requirement.

59 *See, e.g.*, *S.E.C. v. Nutra Pharma Corp.*, 450 F. Supp. 3d 278, 289 (E.D.N.Y. 2020) (denying motion to dismiss in part because whether issuer's statement that it had "engaged [a distributor] to begin the process of regulatory approval" was false and misleading turned on factual question as to reasonable meaning of "engaged").

60 Press Release 2020-237, "SEC Charges Manitex International and Three Former Executives With Accounting Fraud" (Sept. 29, 2020), *available at* https://www.sec.gov/news/press-release/2020-237.

61 *Andeavor LLC*, Exchange Act Release No. 90208 (Oct. 15, 2020).

62 Press Release 2020-258, "SEC Charges Andeavor for Inadequate Control Around Authorization of Stock Buyback Plan" (Oct. 15, 2020), *available at* https://www.sec.gov/news/press-release/2020-258.

63 Former-Chairman Jay Clayton, "Putting Principles Into Practice, The SEC from 2017-2020," *Remarks to the Economic Club of New York* (Nov. 19, 2020), *available at* https://www.sec.gov/news/speech/clayton-economic-club-ny-2020-11-19.

64 Form PF is the confidential reporting form for certain SEC-registered investment advisers to private funds. *See* Proposed Form PF Amendments at 1; Fact Sheet, Proposed Amendments to Form PF, *available at* https://www.sec.gov/files/ia-5950-fact-sheet.pdf.

broadly."[65] The Proposed Form PF Amendments[66] would impose new "current reporting" requirements on certain private funds and expand the type of information required to be reported. In addition, the Proposed Form PF Amendments would significantly expand the universe of advisers subject to Form PF's reporting requirements by decreasing the threshold of AUM required to be a "large private equity adviser."[67] Importantly, however, the Proposed Rule PF Amendments do not change the confidential, nonpublic status of information provided by advisers on Form PF.[68]

A. Overview of Form PF and Proposed Amendments

In the wake of the 2008 financial crisis, then-President Obama signed into law the Dodd–Frank Act "to promote the financial stability of the United States by improving accountability and transparency in the financial system."[69] Sections 404 and 406 of Title IV of the Dodd–Frank Act required the SEC to implement rules expanding the SEC's regulatory oversight over a broader range of investment advisers, including advisers to private funds, such as hedge funds and private equity funds.

The resulting rule required all advisers covered by the Advisers Act who advise private funds with AUM of at least $150 million to complete and file reports on Form PF.[70] The SEC explained that Form PF was intended to enable the Financial Stability Oversight Committee ("FSOC"), a body created by the Dodd–Frank Act, to "to obtain data that will facilitate monitoring of systemic risk in U.S. financial markets."[71] The rule made clear that "[t]he policy judgments implicit in the information required to be reported on Form PF reflect FSOC's role as the primary user of the reported information for the purpose of monitoring systemic risk. The SEC would not necessarily have required the same scope of reporting if the information reported on Form PF were intended solely for the SEC's use."[72]

The rule created the additional reporting requirements for advisers to "large" funds:

- **Large Private Equity Fund Advisers (more than $2B AUM):** Requirement that Form PF be filed annually, 120 days following the end of the adviser's fiscal year, and that Form

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[65] Press Release 2022-9, SEC Proposes Amendments to Enhance Private Fund Reporting (Jan. 26, 2022), *available at* https://www.sec.gov/news/press-release/2022-9?utm_medium=email&utm_source=govdelivery.

[66] Proposed Form PF Amendments at 1.

[67] *Id.* at 8.

[68] The Commission has made clear that "[c]onsistent with provisions under the Advisers Act that provide heightened confidentiality protections for any proprietary information of private fund advisers submitted on Form PF, Commission staff has implemented systems and controls designed to limit access to Form PF data and protect its confidentiality within and outside the agency. This includes limits on access … to internal data systems that contain PF Data to staff experts across the Commission who have been authorized to access the data, and processes under which any Form PF data released to the public is reviewed before release so that the data is aggregated and/or masked to avoid public disclosure of proprietary information of private fund advisers." *See* SEC Annual Staff Report Relating to the Use of Form PF Data, *available at https://www.sec.gov/files/2021-pf-report-to-congress.pdf*:

[69] *See* Dodd-Frank Act, Pub. L. 111-203, 124 Stat. 1376, at preamble.

[70] *See* 17 CFR § 275.204(b)-1.

[71] SEC Release No. IA-3308, "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF; Joint Final Rule" at 8 (Oct. 31, 2021), *available at* https://www.sec.gov/rules/final/2011/ia-3308.pdf (hereinafter, the "2011 Rule Release").

[72] *Id.*

PF include information related to the obligations and leverage of the fund's portfolio companies, debt-to-equity ratios, and aggregate asset values.[73]

- **Large Hedge Fund Advisers (more than $1.5B AUM):** Requirement that Form PF be filed quarterly, 60 days following the end of each fiscal quarter, and that Form PF include information related to significant trading counterparty exposures, trading practices, aggregate exposures and value by asset class, leverage, risk profile, and liquidity.[74]

- **Large Liquidity Fund Advisers**[75] **(more than $1B AUM):** Requirement that Form PF be filed quarterly, 15 days following the end of each fiscal quarter, and that Form PF include information related to asset types, portfolio valuation and valuation methodology, risk profile, and fund compliance policies.[76]

If finalized, the SEC's proposed amendments to Form PF would significantly expand the Form PF reporting requirements for large hedge fund advisers, private equity fund advisers, and large liquidity fund advisers by:

- **Requiring new expedited "current reports":** Advisers to large hedge funds and large private equity funds would be required to file "Current Reports" within one business day of a qualifying "reporting event." "Reporting events" for large hedge funds include: (i) investment losses of 20% or more over a 10-day period; (ii) margin or collateral increases of more than 20%; (iii) defaults; (iv) counterparty defaults; (v) operational disruptions; and (vi) withdrawals or redemptions of 50% or more. "Reporting events" for private equity funds include: (i) removal of a general partner; (ii) adviser-led secondary transactions; and (iii) clawbacks of 10% or more of a fund's capital commitments.[77]

- **Expanding number of advisers subject to disclosure requirements:** The proposed amendments lower the threshold for qualifying as a "large private equity adviser" from $2 billion AUM to $1.5 billion AUM, and would require those advisers to disclose more information on their regularly-scheduled Forms PF, including: "fund strategies, use of leverage and portfolio company financings, controlled portfolio companies ('CPCs') and CPC borrowings, fund investments in different levels of a single portfolio company's capital structure, and portfolio company restructurings or recapitalizations."[78]

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[73] *Id.* at 104-12. The SEC specifically noted that some of the disclosures from private equity funds were "likely to be in private companies whose securities are not widely traded (and, therefore, do not raise the same trading concerns)," and, are thus not subject to the provisions of the Exchange Act. *Id.* at 114 n.343.

[74] *Id.* at 75-97.

[75] Large Liquidity Funds are private funds with greater than $1B AUM that seek to generate income by investing in a portfolio of short term obligations in order to maintain a stable net asset value per unit or minimize principal volatility for investors.

[76] 2011 Rule Release at 97-99.

[77] Proposed Form PF Amendments, at 213-21.

[78] *Id.* at 8-9.

- **Expanding the scope of information required to be reported by liquidity fund advisers:** The proposed amendments would require large liquidity fund advisers to report the same information that money market funds report on Form N-MFP.[79]

A majority of the Commission readily endorsed the proposed expansion of Form PF's reporting requirements, citing information gaps, perceived complexity, increased market volatility, and systemic risks:

> The proposed amendments are designed to enhance FSOC's monitoring and assessment of systemic risk and to provide additional information for FSOC's use in determining whether and how to deploy its regulatory tools. The proposed amendments also are designed to collect additional data for the Commission's use in its regulatory programs, including examinations, investigations and investor protection efforts relating to private fund advisers.
>
> Form PF provides the Commission and FSOC with important information about the basic operations and strategies of private funds and has helped establish a baseline picture of the private fund industry for use in assessing systemic risk. We now have almost a decade of experience analyzing the information collected on Form PF. In that time, the private fund industry has grown in size and evolved in terms of business practices, complexity of fund structures, and investment strategies and exposures. Based on this experience and in light of these changes, the Commission and FSOC have identified significant information gaps and situations where more granular and timely information would improve our understanding of the private fund industry and the potential systemic risk within it, and improve our ability to protect investors.[80]

The proposed rule expressly observes that "recent market events like the March 2020 COVID-19 turmoil and the January 2021 market volatility in certain stocks, have highlighted the importance of receiving current information from market participants during fast moving market events."[81]

Commissioner Peirce (once again, the lone dissenting vote), questioned the import of the proposed amendments, observing that the "enhanced reporting" required by the amendments is not designed to reduce systemic risk, but rather "to provide the Commission with additional information to support its regulatory and enforcement programs."[82] Commissioner Peirce definitively stated her view that the proposed expansion of the use and applicability of Form PF is "a fundamental shift in . . . scope and purpose."[83] Observing that the proposed amendments depend on unproven "links

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[79] *Id.* at 9.
[80] Proposed Form PF Amendments at 4-5.
[81] *Id.* at 7.
[82] Commissioner Hester M. Peirce, Statement on Proposed Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers (Jan. 26, 2022), *available at* https://www.sec.gov/news/statement/peirce-form-pf-20220122.
[83] *Id.*

between certain noteworthy events at one or a handful of funds and the wider market," Commissioner Peirce expressed doubt as to whether "contemporaneous reports from advisers concerning one or a handful of key events are significant enough to justify this added reporting burden for hundreds of advisers."[84]

B. Amended Form PF Could Trigger Increased Enforcement Actions

Regardless of the motives behind the SEC's proposed expansion of Form PF reporting requirements, it is clear that—if enacted as currently proposed—the expanded disclosure obligations may trigger additional enforcement actions. The proposed amendments reflect the Commission's desire to expand its ability "to effectively examine and monitor the private fund space," by collecting real-time information that the Commission deems necessary to "making timely determinations as to whether certain events could pose systemic risks"—including events that impact a single fund, such as margin calls or cybersecurity breaches.[85]

Thus, the proposed amendments will increase the data available to the SEC's Enforcement Division, and will likely expand the array of enforcement actions that the SEC may pursue, in connection with both alleged reporting violations and suspected substantive violations of the securities laws. These new types of enforcement actions could impact both day-to-day operations as well as long-term fund strategy. We discuss each in turn.

1. Enforcement Actions for Failures to File Form PF Are Likely to Increase

The SEC is likely to expand its practice of penalizing advisers who fail to timely file Forms PF.[86] The requirement that Current Reports be filed within 24 hours of a qualifying reporting event, as well as the expanded definition of "large private equity adviser," will provide the Commission with more opportunities to levy penalties against noncompliant advisers. With the SEC's focus on increased monitoring and oversight, the first wave of Form PF enforcement will likely focus on advisers to large private equity funds and hedge funds that fail to make timely or complete Current Reports.

It will be important for fund advisers wishing to remain in compliance with the rule's new reporting requirements to examine and improve their existing processes for gathering information and ensuring timely reporting. The proposed amendments estimate that each Current Report will take 8.5 hours to complete—an extra work-day that must be completed *before* the close of business on the following day.[87] In addition, the Commission estimates that advisers to large private equity funds will spend 25% more time preparing their quarterly and annual Form PF submissions.[88] Funds and advisers that have set aside time each quarter to gather information needed to submit Forms PF may need to hire new personnel or engage outside consultants who can perform the same functions on an expedited schedule.

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84 *Id.*

85 Commissioner Allison Herren Lee, Statement on Proposed Amended to Form PF (Jan. 26, 2022), *available at* https://www.sec.gov/news/statement/lee-form-pf-20220126.

86 *See* Press Release 2018-100, SEC Charges 13 Private Fund Advisers for Repeated Filing Failures (June 1, 2018), *available at* https://www.sec.gov/news/press-release/2018-100.

87 Proposed Form PF Amendments at 134.

88 *Id.* at 129, 132.

2. Uncertainty Concerning the Scope of the Current Report Requirement May Spur Enforcement Actions

There is likely to be considerable debate over whether a particular event requires the filing of a Current Report. Each of the proposed rule's enumerated "reporting events" will present novel issues regarding the scope and applicability of the Current Report requirement. These questions are unlikely to be resolved until the SEC staff issues formal guidance following finalization of the amended rule (and, perhaps, not even then).

To avoid the risk of an enforcement action for non-compliance, many fund advisers are likely to err on the side of caution, overreporting in connection with insignificant events. But such overreporting may give rise to enforcement inquiries where there otherwise would not have been any. And, for those advisers brave enough to forego filing reports in borderline situations, early enforcement actions may test:

- Whether a large hedge fund that experiences a one-day IT outage must file a Current Report of an "Operations Event;"[89]
- Whether the requirement that large hedge funds report a 20% or greater reduction in "net asset value" includes investments in funds of funds as a portion of net asset value, even though investments in funds of funds are otherwise treated as "disregarded assets" on Form PF.[90]
- What constitutes a "material change" to large hedge fund's relationship with its prime broker or brokers sufficient to merit a report on Item F of Section 5.[91]
- Whether the reorganization of a large private equity fund's general partner under the laws of another jurisdiction, without an interruption in operations discernible to investors, qualifies as a "General Partner Removal" that must be reported on Item D of Section 6.[92]

We will close this section with one final conundrum presented to advisers to large hedge funds, presented by Item E of Section 5 of the amended Form PF. This Item requires fund advisers to report—within one day—failures by fund counterparties to "meet a call for margin, collateral, or equivalent" or to "make any other payment in the time and form contractually required" if the amount involved is greater than 5% of net asset value.[93] This Item appears to require hedge fund advisers to declare a default as soon as the hedge fund has a reasonable basis for that position, or potentially face an enforcement action for failing to make a timely disclosure. In subsequent litigation by the potentially defaulting party, failure to file a Current Report could be used as evidence of acquiescence by the hedge fund to the default. In such a scenario, the requirements of the amended Form PF could determine the outcome a private dispute between private parties.

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89 *Id.* at 217.
90 *Id.* at 162-63.
91 *Id.* at 216.
92 *Id.* at 221.
93 *Id.* at 216.

III. Conclusion

The SEC's Proposed Advisor Rules and Proposed Form PF Amendments will, if finalized, meaningfully expand reporting requirements and enforcement risks for private funds, hedge funds, and venture capital funds and significantly reduce the extent to which the private markets operate outside the Commission's focus. Together, these new and amended rules evidence the Commission's efforts to prioritize private fund regulation and to incentivize private fund advisers to adopt robust compliance and disclosure policies. We expect that, in the wake of the new and amended rules, enforcement actions will first focus on failures to make required disclosures and books and records violations, and then quickly turn to use of the data provided under the new reporting regimes to build cases alleging substantive violations of the antifraud provisions of the securities laws. As the SEC turns its lens on the private markets, funds and their advisers may wish to plan ahead and evaluate their compliance, reporting, documentation, and litigation positions.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

Sarah Heaton Concannon
Co-Chair, SEC Enforcement Practice
Email: sarahconcannon@quinnemanuel.com
Phone: 202-538-8122

R. Brian Timmons
Global Head of Complex Litigation
Email: briantimmons@quinnemanuel.com
Phone: 213-443-3221

Alex Zuckerman
Email: alexzuckerman@quinnemanuel.com
Phone: 212-849-7234

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