



Americans for Financial Reform Education Fund

Summary of SEC's Private Funds Proposals

The Securities and Exchange Commission has released two sets of rule proposals that will provide investors and regulators with greater transparency into several aspects of the \$18 trillion private fund industry, which include hedge funds and private equity firms, and empower both investors and regulators to pushback against industry abuses, which have been aided by the secrecy with which they have operated.

Such opacity has allowed private equity executives to siphon off assets from the companies they own, overcharge fees and expenses to their investors and portfolio companies, and attract large amounts of new capital using misleading and inflated performance figures.

They have also sharply restricted regulators' insight into the total risks posed by the \$18 trillion private fund industry to the financial system.

Investor protection and transparency and accountability to investors.

This set of private fund proposals were released on 2/9/22 with comments due on the latter of 30 days after publication in the Federal Register or 60 days after issuance, which would be 4/11/22

Fees and expense disclosures to fund investors

Quarterly reporting of all fees and expenses by investors

- Detailed reporting of all compensation, fees, and other expenses paid to the adviser
- Detailed reporting of all fees and expenses paid to the private fund leading up to the current reporting period

Breakdown of all fees and expenses paid by portfolio companies to the private fund adviser

- Separate table showing total dollar amounts paid in fees including , but not limited to:
 - Origination fees
 - Management fees
 - Consulting fees
 - Monitoring fees
 - Servicing fees
 - Transaction fees
 - Administrative fees
 - Advisory fees

- Closing fees
 - Disposition fees
 - Directors fees
 - Trustees fees
- Private funds ownership percentage of portfolio companies that paid adviser compensation

Improved performance disclosures

Private funds would first need to classify the fund either as liquid or illiquid

Liquid funds

- Would have to disclose performance in quarterly statements
- Annual disclosures on net total returns each calendar year since the fund's inception
- Annual net total returns over 1 year, 5 year, and 10 year period
- Cumulative net total returns for the year and most recent quarter

Illiquid funds

- Gross Internal Rate of Return (IRR) and gross multiple of invested capital
- Net IRR and net multiple of invested capital
- Statement of contributions and distributions
- Returns must be computed without the impact of any fund-level subscription facilities (which can artificially inflate returns)

Disclosure of performance calculation

- Prominent disclosure of criteria and assumptions used to make performance calculations
- SEC is asking for comment on whether other performance metrics should be utilized in the final rule including potentially:
 - Public Market Equivalent (PME)
 - Modified Internal Rate of Return
 - Other less manipulated return metrics

Fairness opinion for secondary fund transactions

- Adviser must obtain fairness opinion where advisers offer fund investors an option to sell their stakes in the private fund
- Opinions can only be provided by an independent opinion provider
- Acknowledging a steady stream of businesses from private funds may lead to biased assessments, an additional summary of any business relationships the independent opinion provider has had with the private fund over the past two years

Restricted actions and fees by private funds

The SEC is proposing to prohibit activities and fees that are against the public interest and that from observation over the past decade, may not be resolved by disclosure and enforcement alone.

Private funds may not charge investors or portfolio companies fees related to:

- Accelerated monitoring fees
- Fees related to investigations or examinations from governmental or regulatory authorities
- Regulatory and compliance expenses
- Fees or expenses related to a portfolio company on a non pro-rata basis
- Financing costs related to borrowed capital or assets

Preferential treatment/side letters

- Prohibition on private funds giving certain investors preferential redemption rights or additional information related to portfolio holdings
- Any preferential treatment must be disclosed to all other current investors in the same fund

Mandatory Audits

- Annual audits by an independent public accountant
- Audited financial statements must be provided in accordance with Generally Accepted Accounting Principles (GAAP)
- Fund audits will evaluate whether the fund adviser's fair value estimates of illiquid investments are consistent with GAAP
- Audited financial statements promptly distributed to fund investors upon completion of audit

Greater disclosures of both private equity holdings and hedge fund stability via Form PF

Background: The other set of rules released on 1/26/22, and due 30 days after appearing on the Federal Register, would require private funds such as hedge funds and private equity funds to provide much more extensive information to the SEC on their holdings and on how they are financed through Form PF

Both hedge funds and private equity funds were completely exempt from any regulatory reporting whatsoever until Dodd-Frank was passed, requiring private funds with over \$150 million in assets to report to the SEC on a quarterly basis their assets and how much the funds are borrowing.

The assets and borrowings of individual funds are confidential and out of the view of the public, but the aggregate data can be shared with other regulatory agencies such as the Financial

Stability Oversight Council (FSOC) and Office of Financial Research (OFR) which monitor systemic financial risks.

Proposed changes: Now the SEC is proposing to require both private equity funds and hedge funds to report to the SEC far greater details about their holdings and any significant changes to their capital base. Such details (which will still be filed with the SEC and can be shared with FSOC) would enable regulators to more actively assess risks to the financial system.

Private equity funds over \$1.5 billion in assets would now have to report::

Under section 4

- What portfolio companies they own
- Financing associated with these portfolio companies
- Investments across other parts of the capital structure of companies (debt, preferred shares, warrants)

Under section 6

- Any transaction by the private fund manager or affiliated persons where their interests in the fund are sold or converted into holdings of another fund managed by the manager
- Date and amount of any “clawback” the General Partner must return back to the fund related to performance-based compensation
- Removal of a fund’s General Partner (GP) or termination of the fund’s investment period

Hedge funds would be subject to a new set of immediate reporting under a new section 5 on Form PF that would require them to report within 1 business day if any of the following events occur. These are events that would suggest instability or further trouble:

Sudden loss events:

- Extraordinary investment losses representing 20% or more of a fund’s net asset value (NAV) over a consecutive 10 day period
- Margin default by one of its counterparties

Sharp jumps in borrowing costs

- Significant increases in borrowing costs where a fund sees its margin requirements increase by 20% or more over a consecutive 10 day period
- A termination or other material change in relationship from a fund’s prime broker

Sudden degradation of the fund’s stability

- Unencumbered cash of a fund declines by 20% or more over a consecutive 10 day period

- Clients requests for redemption of assets representing 50% or greater of the fund's most recent Net Asset Value (NAV)

Operational disruptions

- Any significant disruption to a fund's operational capacity (measured by a 20% disruption from normal capacity) stemming from weather, power outages, cybersecurity attacks, etc.
- Removal of a fund's General Partner (GP) or termination of the fund's investment period
- Date and amount of any "clawback" the General Partner must return related to performance-based compensation back to the fund

Secondary transactions

- Reporting of any transaction by the private fund manager or affiliated persons where their interests in the fund are sold or converted into holdings of another fund by the manager

Timeline for implementation of proposed rules

Upon final passage of rules, the SEC proposes a one-year transition period for private fund advisers to comply with the changes.