Private Equity Law Report pelawreport.com

Feb. 20, 2025

Examinations

Using Elements of the PFAR to Develop an All-Weather Approach to SEC Scrutiny of Private Fund Advisers

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The decision by the U.S. Court of Appeals for the Fifth Circuit (Fifth Circuit) striking down the private fund adviser rules (PFAR) – along with ubiquitous predictions of a softer, gentler SEC under Paul S. Atkins – have understandably led many private fund advisers to breathe a sigh of relief. But even without specific and prescriptive rules, private fund advisers' activities will continue to be scrutinized by today's SEC and subject to examination and enforcement efforts long after the current administration.

As Stephen Cutler, former Director of the SEC's Division of Enforcement, presciently noted, the "pendulum" of securities law enforcement and reform swings both ways over time. Although struck down and overly prescriptive in many of its particulars, the PFAR largely codified positions and principles the SEC has taken and expressed over the years about the need for proper disclosures to avoid or mitigate conflicts of interest. Thus, the PFAR offers a helpful roadmap for steps to consider and action items to execute, particularly as private fund advisers launch new fund products and prepare to update their Form ADV disclosures for 2025.

This article outlines some practical and proactive action items that private fund advisers should consider going forward, based on the requirements in the PFAR, to position themselves effectively for ongoing regulatory scrutiny and to offer best-in-class fund documents and transparency for their investors.

See "Potential Areas of Scrutiny in Future SEC Examinations of PE Sponsors" (Jan. 9, 2025).

Regulatory Next Steps

Although the SEC has declined to litigate the PFAR further, the agency will likely still focus on the topics and themes that were the subject of the PFAR. In particular, the SEC's Division of Examinations will continue to scrutinize the types of conflicts of interest targeted by the PFAR.

As the SEC continues its examination efforts, advisers may consider ways to proactively address certain thematic concerns expressed by the SEC in its recent enforcement actions and throughout the PFAR rulemaking process – *i.e.*, the PFAR, the SEC's adopting release, the proposed rules, debate and discussion by and among SEC commissioners and staff, etc. (collectively, PFAR Rulemaking). In particular, advisers might devote extra attention to the following topics, each of which fall within the SEC's purview as they examine advisers and assess, among other things, potential violations of the general antifraud provisions of the Investment Advisers Act of 1940 (Advisers Act):

- pre-commitment disclosures to investors;
- contractual arrangements;
- ongoing disclosures; and
- policies and procedures.

Beyond helping advisers navigate future SEC examinations, focusing on those key areas could confer other benefits. Most private fund advisers actively endeavour to "do right" by their investors by enhancing their transparency, clarity and other avenues. Improving compliance efforts and disclosure practices in those areas can help advisers identify new and better ways to clearly document the contours of their bargain with investors, as well as provide efficient and transparent disclosure on topics of interest to investors – separate and apart from any legal obligations.

See "PE Industry in 2024: Emerging Trends in GP-LP Negotiations, Fund Structures and Compliance Focuses (Part Two of Two)" (Jan. 25, 2024).

Pre-Commitment Disclosures

The PFAR Rulemaking covered a variety of topics that advisers might consider addressing in pre-commitment disclosures to investors. Although certain topics will feature into longstanding and prominent disclosures for many advisers – even for advisers that have historically included disclosure on a given item – it may be worth re-underwriting and potentially enhancing applicable language.

In particular, many advisers will find it helpful to review the specific conflict of interest concerns identified by the SEC in PFAR Rulemaking to ensure their disclosures appropriately consider those concerns and contain the level of specificity that the SEC expects. A few examples of areas addressed by the PFAR that advisers may find ripe for re-underwriting include:

- disclosure of clawback constructs;
- adviser and related person compensation frameworks at both the fund and portfolio company levels;
- performance information; and
- differential liquidity and/or portfolio-level information rights across other sponsor funds or accounts.

Similarly, advisers may want to consider the level of specificity with which their pre-commitment disclosures anticipate preferential terms expected to be provided to other fund investors, particularly when those terms could have a more direct impact on other investors (*e.g.*, investment excusal or "opt-out" rights).

See "Current Scope of PE-Specific Side Letter Provisions: Industry Trends, Excusal Rights and Placement Agent Representations (Part One of Three)" (Mar. 19, 2019).

Other potential disclosure topics or enhancements are teed up less by the PFAR itself than by the commentary throughout the PFAR Rulemaking. For example, the SEC's skepticism of the role of LP advisory committees (LPACs) was made clear by language in the adopting release. Regardless of whether the Commission's concerns about LPACs are shared or warranted, advisers may consider enhancing pre-commitment (and/or ongoing) disclosures to investors about LPACs and their roles, decision-making processes, etc.

See "LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation" (Feb. 25, 2020).

Further, advisers should ensure that their pre-commitment disclosures generally tie to applicable policies and procedures, particularly in light of continued SEC enforcement in that area.

Contractual Arrangements

Advisers may consider improvements or clarifications to their limited partnership agreements (LPAs) or other operating agreements governing their funds.

Waivers of Fiduciary Duties

Among the lowest hanging fruits – and among the highest risk-adjusted return fruits in terms of minimizing deficiency risk – is the SEC's focus on the waiver of U.S. federal fiduciary duties.

Although the SEC declined to adopt a prohibition on limitation of liability and indemnification for simple negligence in the PFAR, some of the commentary in the adopting release seemed to expand on positions expressed by the SEC in the Interpretation Regarding Standard of Conduct for Investment Advisers that was issued in 2019 (Interpretation). The SEC also brought several enforcement actions throughout 2024 targeting the issue, including its recent settlement with ClearPath Capital Partners, LLC.

Therefore, advisers should review their LPAs – which, for many advisers, will include language outside of specific exculpation and indemnification provisions – to ensure their language is clear that the adviser is not purporting to waive its U.S. federal fiduciary duties, whether directly or indirectly.

See "SEC Sanctions Fund Manager for Misleading Hedge Clauses Despite Accompanying Savings Clauses" (Oct. 17, 2024); and this three-part series on navigating the Interpretation: "What It Means to Be a Fiduciary" (Dec. 3, 2019); "Six Tools to Systemically Identify Conflicts of Interest" (Dec. 10, 2019); and "Three Tools to Systemically Monitor Conflicts of Interest" (Dec. 17, 2019).

Other Focus Areas

Although the SEC has long been focused on the specificity of expense provisions more generally, there will likely be greater scrutiny around operative LPA language (and corresponding disclosures) where advisers look to charge their funds for categories of expenses that were targeted in the PFAR, such as:

- investigations by governmental or regulatory authorities;
- examination-related costs; and
- compliance-related expenses.

Further, advisers may want to focus on other LPA provisions addressed in the PFAR Rulemaking relating to investor withdrawal and information rights, clawbacks and LPACs.

Similarly, advisers can expect continued scrutiny of other long-standing SEC focus areas, such as the provision of services to funds and/or portfolio companies by employees, related personnel, or affiliated or quasi-affiliated entities of the private fund adviser.

Ongoing Disclosures

Advisers should also consider incorporating learnings from the PFAR Rulemaking across a variety of forums for ongoing disclosures.

Third-Party Relationships

The PFAR contained what would have been a new Rule 211(f)(2)-2 under the Advisers Act, which would have required advisers to distribute to investors a written summary of any material business relationships with the provider of the – under the PFAR, required – fairness or valuation opinion relating to a proposed adviser-led secondaries transaction. Although the adopting release states that materiality would require a facts and circumstances analysis, it also notes that "for purposes of this rule, audit, consulting, capital raising, investment banking, and other similar services would typically meet this standard."

It is easy to contemplate the SEC taking the view in the context of an examination that consent to an adviser-led secondary transaction was defective where, as always viewed in hindsight, material relationship matters bearing upon the independence of the opinion provider were not disclosed. That view is likely to also be applied to a range of other transactions when consent is solicited from an LPAC or investors generally, as the SEC could take the view that steps or processes purporting to offer a level of third-party validation or independent protection either did not do so at all or were inconsistent with the manner presented to investors.

See "The Merits and Shortcomings of the Diligence-Lite Approach to GP-Led Transactions" (Oct. 25, 2022).

Supplemental Disclosures

Although the PFAR Rulemaking offers many other topical opportunities for ongoing disclosures, most likely fall within the purview of the Fifth Circuit's statement that "[t]he Commission conflates a 'lack of disclosure' with 'fraud' or 'deception' . . . but a failure to disclose 'cannot be deceptive' without a 'duty to disclose.'"

Regardless of any duty or other requirement, there are certain topics where advisers may simply elect to provide supplemental disclosure (*i.e.*, not required by a fund's LPA or other governing documents) to their investors and/or LPACs. Those disclosures, in turn, may become assets to the adviser in the course of navigating an SEC exam. Those sorts of supplemental disclosures are common and may be delivered by advisers for a variety of reasons, including when they believe disclosing information will help investors or where standardized disclosure to a broader group of investors may more efficiently preempt questions that investors would otherwise ask.

For example, advisers might provide additional information about the calculation of a clawback liability. Clawback scenarios set forth in LPAs typically contain a preexisting written forum (*e.g.*, a reporting framework to LPACs or investors) that advisers may find easy to supplement. Rather than looking to satisfy a prescriptive reporting regime, supplemental disclosures may contain data points or other information that the adviser believes will be of the highest value to investors.

Regardless of any such supplemental disclosures, advisers should remain mindful of contractual disclosure requirements applicable to LPACs or investors generally, particularly on topics where the SEC has demonstrated a historical focus.

Policies and Procedures

Advisers should take advantage of the breathing room afforded by the vacatur of the PFAR and the likely shift in SEC enforcement priorities under the Trump administration to review certain aspects of their policies and procedures and incorporate learnings from the PFAR Rulemaking.

For example, advisers may look to what would have been Rule 211(h)(2)-1 under the Advisers Act on restricted activities and re-underwrite the appropriateness of certain expense allocations. Or advisers may look to what would have been Rule 211(h)(2)-3 under the Advisers Act on preferential treatment to ensure their non-disclosure agreement templates sufficiently protect against investors using information provided by the adviser for trading or other activities outside of the fund itself.

See "How ILPA's Model NDA Could Change Preliminary Due Diligence Practices" (Feb. 16, 2021).

In addition to bolstering their policies and procedures, advisers should also ensure their operational processes – both internally by the adviser, as well as externally through their service providers – match those revised compliance policies (*i.e.*, "do what you say").

Concluding Thoughts

Although the SEC's near-term enforcement priorities will likely return to a focus on the sorts of "core" topic areas pursued in the years before Chair Gary S. Gensler, the Commission will continue to provide oversight of private fund advisers. Ordinary course adviser examinations conducted by SEC staff under Atkins are likely to look and feel similar to those conducted under Gensler. Further, private fund governing documents and disclosures that are drafted and negotiated today will remain subject to SEC scrutiny and potential enforcement, not only today or over the next four years, but also as the pendulum shifts over time.

Certainly, advisers can breathe a sigh of relief at avoiding the requirement to comply with the time-consuming, costly and burdensome new obligations that would have been imposed under the PFAR, as well as a less aggressive – or at least less novel – near-term enforcement environment. That means advisers can get back to the business of continuously re-underwriting what really matters to their investors and deciding how to most clearly and effectively document and disclose the bargain with their investors.

As part of that process, the SEC's views expressed throughout the PFAR Rulemaking provide a helpful "checklist" of terms and conduct the SEC may view as objectionable, or at least suspect, for advisers to consider alongside their fund documents and compliance and operating processes. In line with the adage that "the best defense is a good offense," advisers can position themselves most effectively for ongoing regulatory scrutiny by taking a proactive approach to topics addressed by the PFAR Rulemaking and more generally scrutinized by the SEC under Gensler.

See this two-part series on Gensler's tenure at the SEC: "Examination Practices, Enforcement Efforts and Industry Guidance" (Feb. 6, 2025); and "Rulemaking, Culture and Operational Proficiency, and Relationship With Private Funds Industry" (Feb. 20, 2025).

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