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Significant New Private Fund Rules Adopted by SEC

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On August 23, 2023, in its efforts to promote transparency for investors by increasing visibility into compensation schemes, sales practices, and conflicts of interest, the US Securities and Exchange Commission (SEC) adopted significant new and amended Rules under the Investment Advisers Act of 1940 that extensively change the reporting, disclosure and other obligations imposed on private fund investment advisors.

The SEC Rules can be found here.

The final rules:

1. require registered investment advisors to provide certain disclosures in quarterly statements to private fund investors;
2. require all investment advisors to make certain disclosures of preferential terms offered to prospective and current investors;
3. with certain exceptions, prohibit all private fund advisors from providing certain types of preferential treatment that the advisors reasonably expect to have a material negative effect on other investors;
4. restrict all private fund advisors from engaging in certain activities with respect to the private fund or any investor in that private fund, with certain exceptions for when the advisor satisfies certain disclosure requirements and, in some cases, when the advisor also satisfies certain consent requirements;
5. require a registered private fund advisor to obtain an annual financial statement audit of a private fund and, in connection with an advisor-led secondary transaction, a fairness opinion

or valuation opinion from an independent opinion provider; and
6. impose compliance rule amendments and recordkeeping requirements, including certain requirements that apply to all advisors.

The final rules as adopted by the SEC will impose significant compliance requirements on private fund investment advisors (registered and unregistered), but promise to increase the scope of information and disclosures that are universally available to all private fund investors. The specific requirements of the Rules relevant to our clients are further set forth in detail below.

Rules Applicable to Registered Investment Advisors

Quarterly Statements

In order to prevent fraudulent, deceptive, and manipulative practices and allow private fund investors to monitor and compare their investments, an SEC-registered advisor must provide investors with, and retain records related to, standardized quarterly statements to comply with the new Rule 275.211(h)(1)-2 of the Advisers Act. The quarterly statement must include tables that detail advisor compensation and fund expenses, portfolio investment level compensation paid to the advisor or its related persons, and performance metrics for each of the advisor's private funds and must include assumptions and methodology used in the advisor's calculations and provide cross-references to the relevant sections of organizational documents authorizing performance-based compensation and fees. For regular private funds, quarterly statements are due to investors 45 days after the end of the first three fiscal quarters, and 90 days after the end of the fiscal year. For funds-of-funds, quarterly statements are due 75 days after the end of the first three fiscal quarters, and 120 days after the end of the fiscal year.

At the private fund level, first, the quarterly statement must include a detailed accounting of all compensation, fees, and other amounts allocated or paid to the advisor or any of its related persons (broadly defined) by the private fund, and a detailed account of all other fees and expenses allocated to or paid by the private fund, presented both before and after any offsets or rebates carried forward to the reporting period. Items must be presented as a separate line items; the Rules do not permit grouping expenses.

At the portfolio investment level, the quarterly statement must include a detailed accounting of any compensation, fees, and other amounts allocated or paid to the investment advisor or any of its related persons by a portfolio investment, presented before and after the application of offsets, rebates, or waivers. Advisors will need to determine whether the entity paying the investment advisor is a "portfolio investment" under the Rules, which may present challenges for fund-of-fund advisors.

Finally, the quarterly statement must include standardized fund performance information, which will vary depending on whether the private fund is categorized as "illiquid" or "liquid." Advisors must determine, and keep records related to, whether a fund is illiquid, defined as a private fund that (1) is not required to redeem interests upon an investor's request and (2) has limited opportunities, if any, for investors to withdraw before the private fund's determination. If a fund is not an illiquid fund, it is a liquid fund. Liquid funds must include in their quarterly statements the net total return on an annual basis for the 10 prior fiscal years, the average annual net total returns on the one-, five-, and 10-year fiscal periods, and the net total return on a cumulative basis for the current fiscal year. Illiquid funds must include the gross internal rate of return and gross multiple of invested capital, the net internal rate of return and net multiple of invested capital, and the gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the portfolio (shown separately), all with and without the impact of fund-level subscription facilities. Advisors must also include a statement of contributions and distributions reflecting aggregate cash inflows and cash outflows next to the fund's net asset value.

As a result of the Rules, advisors will need to begin contacting accounting and recordkeeping vendors to enter or renegotiate agreements, develop internal policies and procedures, and retrieve archival information as necessary to adequately prepare for compliance with the Rules. Further, advisors should consult with counsel to ensure their form quarterly statements are in compliance with the Rules, and further provide adequate time for counsel to review each quarterly statement for compliance.

Mandatory Private Fund Adviser Audits

In order to address fraud concerns related to the valuation process, under the Rules, an SEC-registered advisor must cause each private fund that it advises, either directly or indirectly, to conduct an annual financial statement audit in compliance with the audit provisions of Rule 206(4)-2 of the Advisers Act, commonly referred to as the custody rule. In order to comply with the Rules, the annual audit must be performed by an independent public accountant that is registered and subject to inspection by the Public Company Accounting Oversight Board and meet the definition of audit in under Regulation S-X. Additionally, the audited statements must be prepared in accordance with GAAP and be delivered to investors within 120 days of the fund's fiscal year end (180 days for a fund of fund and 260 days for a fund of funds of funds) and promptly upon liquidation. The advisor must also keep a copy of any audited financial statements, along with a record of each addressee and the corresponding date(s) sent. Notably, SEC-registered advisors will not be able to rely on the surprise examination option under the custody rule for purposes of compliance with the annual audit requirement under the Rules. As a result of the new audit requirements under the Rules, SEC registered advisors will need to make appropriate plans, potentially including hiring an independent auditor, to comply.

Advisor-Led Secondaries

Advisors with $1.5 billion or more in assets under management must comply within 12 months after the Rules are published in the Federal Register; we anticipate this compliance date to be in Fall 2024. Advisors with less than $1.5 billion in assets under management must comply within 18 months; we anticipate this compliance date to be in early 2025.

The Rules require SEC-registered advisors to obtain and provide to investors a fairness opinion or a valuation opinion in connection with an advisor-led secondary transaction. The Rules define an "adviser-led secondary transaction" as any transaction in which the advisor or any of its related persons offer the private fund's investors the option of either (a) selling all or a portion of their fund interests, or (b) converting or exchanging all or a portion of such interests for interests in another vehicle advised by the advisor or any of its related persons. The SEC notes that rebalancing fund interests between parallel entities and "season and sell" transactions would not be captured by the definition, since no option or choice is presented to investors in such transactions.

The Rules also enhance conflict-of-interest protections in secondary transactions by requiring the advisor to prepare and distribute to investors a summary of any material business relationship the advisor has, or has had within the prior two years, with the independent provider of such option. Finally, the Rules require advisors to make and retain books and records to support their compliance with these rules and facilitate the SEC's inspection and enforcement thereof.

The SEC's view is that, since the advisor is on both sides of an advisor-led secondary transaction, advisors may seek to overvalue or undervalue the underlying asset in the transaction. The advisor may also have other economic interests in the transaction based on management fees, carried interest or other fees or benefits it may earn conditional on the closing of the transaction. This conflict of interest and the attendant risks to investors may be mitigated by the increased disclosure requirements and requirement to obtain a third-party valuation.

Rules Applicable to All Investment Advisors

Restricted Activities

Under the Rules, a private fund advisor is restricted from engaging in certain sales practices, conflicts of interest, and compensation schemes in order to prevent certain activities that could result in fraud and investor harm. However, an advisor may engage in certain restricted activities, so long as they provide the appropriate specified disclosure and, in some cases, obtain investor consent.

Specifically, the Rules restrict an investment advisor from engaging in the following activities:

- **Investigatory Fees and Expenses.*** An advisor cannot charge a private fund for fees or expenses related to an investigation of the advisor or its related persons by any governmental or regulatory authority **unless** a majority in interest of investors that are not related persons of the advisor consent to such charge. However, regardless of any consent, the advisor cannot charge fees and expenses related to an investigation if such examination or investigation results in sanctions against the advisor for violation of the Advisers Act.
- **Regulatory and Compliance Fees and Expenses.** An advisor cannot charge or allocate regulatory or compliance fees and expenses, or fees and expenses associated with an examination of the advisor or its related persons, **unless** such fees and expenses are disclosed to investors within 45 days of the end of the fiscal quarter in which the charge occurs. An advisor may charge for regulatory, compliance, and other similar fees and expenses *directly* related to the activities of the private fund, such as a Form D.
- **Reducing Advisor Clawbacks for Taxes.** An advisor cannot reduce the amount of any advisor clawback by actual, potential, or hypothetical taxes applicable to the advisor, its related persons, or their respective owners or interest holders, **unless** the advisor discloses the pre-tax and post-tax amount of the clawback to investors within 45 days of the end of the fiscal quarter in which the clawback occurs. As an example of disclosure that may satisfy the requirement, an advisor that is subject to a clawback could at the end of the fund's term include disclosure in the fund's quarterly statement (to the extent that the quarterly statement is delivered within 45 days following the end of the relevant fiscal quarter).
- **Certain Non-Pro Rata Fee and Expense Allocations.** An advisor cannot, directly or indirectly, charge or allocate fees and expenses related to a portfolio investment, or potential portfolio investment, on a non-pro rata basis when multiple private funds and other clients advised by the advisor or its related persons have invested, or propose to invest, in the same portfolio investment (e.g. parallel funds, co-investment vehicles, etc.), **unless** (1) the charge or allocation is fair and equitable under the circumstances, *and* (2) the advisor provides written notice of the non-pro rata charge or allocation with an explanation as to why it is fair and equitable under the circumstances.
- **Borrowing.*** An advisor cannot, directly or indirectly, borrow money, securities, or other fund assets, or receive a loan or an extension of credit from a private fund client, **unless** the advisor provides a written description of the material terms of the borrowing, loan, or extension of credit, *and* a majority in interest of investors consent. An advisor may borrow

from a third party on the fund’s behalf and may lend money to the fund.

*For private funds that have already commenced operations as of the compliance date and compliance with this provision of the Rule would require the private fund to amend an operational agreement, subscription agreement, side letter, or credit document, the SEC will provide “legacy status” to those agreements and not require compliance with this specific provision.

Preferential Treatment

In order to address the conflict of interest associated with granting preferential treatment to certain investors but not others, all private fund advisors (other than an advisor to SAFs with respect to such funds) are prohibited from “directly or indirectly granting an investor in a private fund or in a similar pool of assets the ability to redeem its interest on terms that the advisor reasonably expects to have a material, negative effect on other investors in that private fund or in a similar pool of assets.” There are two exceptions. First, redemptions that are required by applicable law, rule, regulation or order of certain governmental authorities are not affected. Second, the above prohibition does not apply if the advisor “offers the same redemption ability to all existing and future investors in the private fund or similar pool of assets.”

The private fund advisors referenced above are also prohibited from directly or indirectly “providing information regarding the portfolio holdings or exposures of the private fund, or of a similar pool of assets, to any investor in the private fund it the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a similar pool of assets.” There is one exception: where the advisor “offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time,” the prohibition does not apply.

Finally, the private fund advisors referenced above are prohibited from “providing any other preferential treatment to any investor in a private fund unless the adviser provides written disclosures to prospective investors of the private fund regarding preferential treatment related to any material economic terms, as well as written disclosures to current investors in the private fund regarding all preferential treatment, which the advisor or its related persons has provided to other investors in the same fund.”

Note that the first two prohibitions only apply to preferential treatment that has a material, negative effect on other fund investors. It is important to note that each advisor is required to objectively (not subjectively) determine whether the preferential treatment would have a material, negative effect on other fund investors based on what the advisor reasonably expects at the time. To make the determination, advisors should remember the SEC’s purpose in promulgating the Rules: to “ensure that investors have access to information necessary to diligence the prospective investment and better understand whether, and how, such terms affect the private fund overall” so that investors can make more informed decisions, both now and in the future.

Nevertheless, the Rules will impact the negotiation of side letters. While the Rules do not prohibit certain terms wholesale, with few exceptions, advisors may only grant certain preferential treatment to investors if the advisor provides the applicable disclosures to other investors. These requirements may impact advisors’ willingness to offer certain terms in side letters at all. For private funds that have already commenced operations as of the compliance date and compliance with the prohibitions aspect of the preferential treatment rule would require the private fund to amend an already-binding operational agreement, subscription agreement, side letter, or credit document, the SEC will provide "legacy status" to those agreements and not require compliance with that specific provision.

Deadlines for Compliance

Advisors must comply with the Quarterly Statement Rule and Audit Rule within 18 months after the Rules are published in the Federal Register; we anticipate this compliance date to be in early 2025.

Advisors with $1.5 billion or more in assets under management must comply with the Adviser-Led Secondaries Rule, Preferential Treatment Rule, and Restricted Activities Rule within 12 months after the Rules are published in the Federal Register; we anticipate this compliance date to be in Fall 2024. Advisors with less than $1.5 billion in assets under management must comply with the Rules within 18 months; we anticipate this compliance date to be in early 2025.

All advisors must comply with the amended Advisers Act Compliance Rule within 60 days after publication in the Federal Register. We anticipate this compliance date to be in Fall 2023.

Pushback from Fund Managers

On September 1, 2023, private fund trade groups, including the National Association of Private Fund Managers, Alternative Investment Management Association Ltd., American Investment Council and several others, filed a petition for review of the SEC's adoption of the Rules. The trade groups argue that the Rules: (a) exceed the SEC's authority, (b) were adopted without compliance with notice and comment requirements; and (c) are otherwise "arbitrary, capricious, and abuse of discretion and contrary to law" in violation of the Administrative Procedure Act. In particular, the trade groups argue that the Rules would prohibit investors from negotiating beneficial terms with funds that meet investors' particular needs and would impose costly and unnecessary reporting. As evidenced by fund manager pushback, these Rules may impose significant and costly burdens directly on fund managers and indirectly on investors.

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