ALERTS

SEC Adopts Final Rule Governing Private Fund Advisers

August 25, 2023

Highlights

As adopted, many of the more drastic changes under the SEC's proposal have been meaningfully moderated, and certain elements have been omitted completely

Despite these changes, the final rule contains a number of onerous obligations for private fund advisers

Unlike the proposed rules, the final rules grandfather certain arrangements that private funds have put in place prior to the compliance date, sparing managers the need to renegotiate existing agreements

On Aug. 23, 2023, the Securities and Exchange Commission (SEC) adopted new and long-awaited rules under the Advisers Act, aimed at enhancing the regulation of private fund advisers and intended to address certain practices that the SEC perceived as being potentially risky and harmful to investors. The proposed rules, released in February 2022, would have meant sweeping changes to the private fund industry. Many of the more drastic proposed changes were toned down or omitted

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Rules for Private Fund Advisers

The scope of advisers that are subject to the final fund adviser rules has generally not changed since the proposal, as certain aspects only apply to SEC-registered investment advisers (“RIAs”) to private funds while other components apply to all advisers to private funds (registered or not).

Applicable to SEC-Registered Private Fund Advisers	• Quarterly Statement Rule • Audit Rule • Adviser-Led Secondaries Rule
Applicable to All Advisers to Private Funds	• Restricted Activities Rule • Preferential Treatment Rule

A. Rules Applicable to RIAs Only

1. Quarterly Statement Rule

The SEC’s stated goal in enacting Rule 211(h)(1)-2 (the “**Quarterly Statement Rule**”) is to facilitate the adviser’s provision of simple disclosures to investors with respect to certain fundamental terms governing their private fund investments. Specifically, this rule will require disclosure of the fees and expenses those investors will pay and the performance of such investments. In addition, RIAs will be required to provide information regarding any compensation paid to the adviser or its related persons by the fund, and any compensation paid or allocated to such persons by the fund’s underlying portfolio investments.

At a high level, the fee and expense disclosure component of the Quarterly Statement Rule includes three categories of required information:

i. Private fund-level disclosure, in a table format providing specific disclosure regarding adviser compensation, fund fees and expenses and any fee offsets, rebates or waivers;
ii. Portfolio investment-level disclosure, likewise in a single table providing a detailed accounting of all “portfolio investment compensation” that is allocated or paid by each “covered portfolio investment” during the reporting period; and
iii. Calculation detail and cross-references to organizational and offering documents, which requires prominent disclosure of the manner in which the information contained in the quarterly statement is calculated, as well as cross-references to the applicable sections of the fund’s organizational and offering documents that describe the calculation methodology.

In addition to the fee and expense disclosure, the Quarterly Statement Rule also requires advisers to provide standardized fund performance

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information. The required information varies depending on whether the relevant fund is considered liquid (generally a fund allowing voluntary redemptions or withdrawals) or illiquid (closed-end funds), but all required performance categories must be displayed with equal prominence.

In short, advisers to liquid funds must include (a) net total return on an annual basis for the last 10 fiscal years (or since the fund's inception, if shorter), (b) average annual net total returns over one-, five-, and 10-fiscal year periods and (c) the cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter.

For illiquid funds, advisers must provide the fund's (a) gross internal rate of return (IRR) and gross multiple of invested capital (MOIC), (b) net IRR and net MOIC and (c) gross IRR and gross MOIC for the realized and unrealized portions of the fund's portfolio (showing realized and unrealized performance on a disaggregated basis). This illiquid fund information must be computed both with and without the impact of any fund-level subscription facilities (so, both levered and unlevered returns). Lastly, advisers to illiquid funds must provide a statement of contributions and distributions to investors.

Under the Quarterly Statement Rule, such quarterly statements must be distributed to investors in private funds within 45 days of the first three fiscal quarters (based on the fund's fiscal periods) and within 90 days of the end of each fiscal year; funds of funds are provided 75 and 120 days, respectively.

2. Mandatory Private Fund Adviser Audit Rule

According to the SEC, new Rule 206(4)-10 (the "**Audit Rule**") is aimed at protecting funds and their investors against potential misappropriation of fund assets, and providing a check on both the adviser's valuation of fund assets and on certain conflicts of interest between the adviser and the investors.

In general, the substance of the rule was adopted largely unchanged from the proposal, though the final rule was modified in an effort to reconcile differences with Rule 206(4)-2 under the Advisers Act (the "custody rule"). Under the new Audit Rule, registered investment advisers must cause private funds to undergo audits in accordance with the applicable provisions of the custody rule:

i. The audit must be performed by an independent public accountant that meets certain standards;
ii. The audit must meet a specific definition of audit;
iii. Audited financial statements must be prepared in accordance with GAAP;
iv. Annually within 120 days of the fiscal year-end and promptly upon liquidation, the private fund's audited financial statements are delivered to investors in the private fund.

It is worth noting that because a surprise examination does not meet the above requirements, surprise exams are effectively eliminated as an option for private funds advised by RIAs.

One change from the proposal was to eliminate a requirement that an adviser enter into a contract with the independent public accountant to notify the SEC (i) promptly if it issues an audit report containing a modified opinion and (ii) within four business days of the termination of the engagement. The SEC is not adopting this requirement and will instead continue to consider comments on its proposed amendments to the custody rule, in an effort to align the audit requirements across both rules.

3. Adviser-Led Secondaries Rule

Under Rule 211(h)(2)-2 (the "**Adviser-Led Secondaries Rule**"), the SEC will require RIAs engaging in an adviser-led secondary transaction, defined as "a transaction that offers fund investors the option between selling all or a portion of their interests in the private fund and converting or exchanging them for new interests in another vehicle advised by the adviser or any of its related persons," to satisfy two new requirements.

First, an adviser engaging in such a transaction will need to obtain either a written opinion stating (a) that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair (a "fairness opinion") or (b) the value of any assets being sold (a "valuation opinion") from an independent opinion provider. Such opinion must be distributed to investors before the investors must make a binding election. Unlike the proposed rule (which would have required a fairness opinion), the adviser has the option to choose which type of opinion is delivered, which may be influenced in practice by negotiation with investors.

In addition, the adviser will need to put together, and distribute, a written summary of any material business relationships that the adviser or any of its related persons has (or has had) with the independent opinion provider within the two-year period leading up to the fairness or valuation opinion. Such summary must also be distributed to fund investors before the investors must make a binding election.

B. Rules Applicable to All Advisers to Private Funds (Registered or Not)

1. Restricted Activities Rule

In a significant change from the proposal, the SEC's new Rule 211(h)(2)-1 (the "**Restricted Activities Rule**") does not categorically foreclose a significant list of industry practices. Rather, with one exception, the Restricted Activities Rule only requires adequate disclosure – and in some cases consent – in order for an adviser to engage in such specified practices.

The sole strict prohibition under the Restricted Activities Rule will be the charging or allocation to any private fund of fees and expenses relating to any investigation of the adviser or its related persons that results in the imposition of sanctions for violating the Advisers Act. Otherwise, the Restricted Activities Rule only restricts the following activities if the specified disclosure and/or consent is not provided:

i. Charging/allocating to a private fund fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority unless the investment adviser obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser;

ii. Charging the private fund for any of the adviser's regulatory, examination or compliance fees or expenses unless the investment adviser distributes a written notice of any such fees or expenses, and the amount thereof, to the investors of such fund client in writing within 45 days after the end of the applicable quarter;
iii. Reducing the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the adviser unless the investment adviser distributes a written notice to fund investors setting forth the pre- and post-tax clawback amounts before and after any reduction for actual, potential, or hypothetical taxes within 45 days after the end of the applicable quarter;
iv. Charging or allocating fees and expenses related to a portfolio investment on a non-pro rata basis if more than one private fund or other client advised by the adviser have invested in the same portfolio company unless (a) the non-pro rata charge or allocation is fair and equitable and (b) the investment adviser provides advance notice to each investor of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances; and
v. Borrowing or receiving a loan or other extension of credit from a private fund client, unless the investment adviser distributes to each investor a written description of the material terms and obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser. (The SEC clarified that it would not interpret ordinary tax advances or management fee offsets as borrowings subject to this rule.)

For each consent-based exception, the SEC provided that a fund's governing agreements can specify the manner and process for obtaining consent. However, obtaining consent through a limited partner advisory committee (LPAC) or a similar body in lieu of the fund investors themselves would not be permissible.

1. <u>Preferential Treatment Rule</u>

The SEC's new Rule 211(h)(2)-3 (the "**Preferential Treatment Rule**") is also significantly modified from the proposed rule. The SEC had initially proposed that such private fund advisers could not:

i. grant a private fund investor the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that fund;
ii. provide information regarding portfolio holdings or exposures of a private fund to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that fund; or
iii. provide any other preferential treatment to any investor in the private fund unless the adviser delivers certain written disclosures to prospective and current investors regarding all preferential treatment the adviser or its related persons provide to other investors in the same fund; such disclosure would have needed to occur prior to the investor's investment in the applicable fund for new investors and on an annual basis for existing investors.

With respect to the prohibition on certain preferential redemption rights, the final Preferential Treatment Rule is tempered and now includes two exceptions: (i) for redemptions required by applicable law and (ii) if the adviser has offered the same redemption ability to all existing investors and will continue to offer the same redemption ability to future investors in the private fund or similar pool of assets.

Regarding the prohibition on preferential information rights, the Preferential Treatment Rule is likewise modified by providing an exception where the adviser offers such information to all other existing investors in the private fund at substantially the same time. Unlike with the redemption rights, though, there is no exception for preferential information rights that an investor must obtain as a requirement of law, as the SEC argued that any such information could be provided to all investors.

In addition, the SEC narrowed the reporting requirement under the Preferential Treatment Rule so that advance written notice applies only to material economic terms. However, the Preferential Treatment Rule still requires specific and comprehensive annual disclosure of all preferential treatment to the adviser's current investors.

In another change from the proposed rule, advisers are required to provide current investors with written notice of all preferential treatment that the adviser has provided to other investors in the same private fund, the timing of which will vary depending on the type of fund. For an illiquid fund, notice must be provided as soon as reasonably practicable following the end of the fund's fundraising period; for a liquid fund, notice must be provided as soon as reasonably practicable following the investor's investment in the private fund.

Grandfathering Provisions

The SEC is providing legacy status for the prohibitions aspect of the Preferential Treatment Rule and the aspects of the Restricted Activities Rule that require investor consent. The legacy status provisions apply to governing agreements that were entered into prior to the compliance date (as described below) if the applicable rule would require the parties to amend the agreements.

Amendments to Books and Records Requirements and Compliance Rule

The "books and records rule" (Rule 204-2 under the Advisers Act) is amended to provide additional recordkeeping requirements with respect to the various provisions under the new rules.

In addition, the SEC adopted an amendment to the "compliance rule" (Rule 206(4)-7 under the Advisers Act), which will require all RIAs (including those that do not advise private funds) to document in writing the required annual review of their compliance policies, emphasizing the importance of a written record for the SEC's examination staff. These amendments were adopted substantially in the form proposed.

Other Key Changes From the Proposed Rules

In addition to the changes from the proposed rules noted above, there were other significant modifications to the proposal. The SEC did not adopt its proposed prohibition on charging fees for unperformed services – there will not be an express prohibition on charging a portfolio company for monitoring, servicing, consulting or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment. However, the SEC noted that it believed such prohibition to be unnecessary because such activity would be inconsistent with an adviser's fiduciary duties.

The SEC also did not adopt its proposal to prohibit an adviser from seeking reimbursement, indemnification, exculpation or limitation of 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 ("waiver or indemnification prohibition"). The SEC explained that it considers such a prohibition to be unnecessary, and clarified the applicability of an adviser's fiduciary duty to its private fund clients and of the anti-fraud provisions to the adviser's dealings with its clients and fund investors. In the adopting release, the SEC also provided examples showing how their fiduciary interpretation will apply to certain facts and circumstances.

Effective Date

For the Audit Rule and the Quarterly Statement Rule, the compliance date will be 18 months after the date of publication in the Federal Register. For the Adviser-Led Secondaries Rule, the Preferential Treatment Rule and the Restricted Activities Rule, the compliance dates vary based on the size of the adviser: for advisers with $1.5 billion or more in private funds assets under management (AUM), the compliance date is 12 months after the date of publication in the Federal Register; for advisers with less than $1.5 billion in private funds AUM, the compliance date is 18 months after the date of publication in the Federal Register. Compliance with the amended Advisers Act compliance rule will be required 60 days after publication in the Federal Register.

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