

## Insights

# SEC ADOPTS LONG-AWAITED FINAL RULES FOR PRIVATE FUND ADVISERS

Aug 25, 2023

On August 23, 2023, in a 3-2 vote, the U.S. Securities and Exchange Commission (the “SEC”) adopted new rules (the “Final Rules”) under the Investment Advisers Act of 1940 (the “Advisers Act”) primarily affecting investment advisers to private funds (“Private Fund Advisers”). The Final Rules significantly broaden and increase regulatory and other compliance requirements for Private Fund Advisers.

The Final Rules retracted some of the more prescriptive and onerous aspects of the February 2022 proposed rules, most notably the proposed rules’ restrictions on commonly accepted industry practice regarding exculpatory and indemnification standards.

Following is a brief summary of the most significant requirements of the Final Rules.

## REGISTERED PRIVATE FUND ADVISERS

The Final Rules impose the following obligations on registered Private Fund Advisers and those subject to registration, but not on exempt reporting advisers:

**Quarterly Statement Rule.** A Private Fund Adviser must distribute to private fund investors a quarterly statement including the (1) performance; (2) investment costs; and (3) fees and expenses of any private fund, as well as compensation and other amounts the Private Fund Adviser receives. The Quarterly Statement Rule will require specific tables that disclose:

- A detailed accounting of all compensation, fees, and other amounts allocated or paid to the Private Fund Adviser or any of its related persons by the private fund (“adviser compensation”) during the reporting period;
- A detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period in addition to adviser compensation (“fund expenses”); and
- The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the Private Fund

Adviser or its related persons.

Should a Private Fund Adviser disseminate such quarterly statements in a manner such that they might be deemed an “advertisement” under Rule 206(4)-1 under the Advisers Act (the “Marketing Rule”), the quarterly statements must comply with both the Quarterly Statement Rule and the Marketing Rule.

**Private Fund Audit Rule.** A Private Fund Adviser must obtain an audit of each private fund on at least an annual basis. A Public Company Accounting Oversight Board (“PCAOB”) registered independent public accountant must perform the audit, and the Private Fund Adviser must deliver the audited financial statements within 120 days of the end of the fund’s fiscal year to the fund’s investors. The audit requirement largely corresponds with the existing audit practices of many Private Fund Advisers under Rule 206(4)-2 under the Advisers Act (the “Custody Rule”). The principal consequence of the Final Rules is that Private Fund Advisers will no longer be able to rely on the surprise examination option under the Custody Rule in lieu of obtaining an audit.

**Adviser-Led Secondaries Rule.** A Private Fund Adviser must obtain an independent fairness opinion or valuation opinion when offering existing fund investors the option of (1) selling their interests in a private fund or (2) converting or exchanging their interests in the private fund for interests in another vehicle advised by the Private Fund Adviser or any of its related persons. The Final Rules also require the Private Fund Adviser to prepare and distribute to the private fund’s investors a summary of any material business relationships the Private Fund Adviser has, or has had within the prior two years, with the independent opinion provider.

**Books and Records Rule Amendments.** A Private Fund Adviser must also comply with additional books and records obligations to assist the SEC’s ability to assess the Private Fund Adviser’s compliance.

## ALL PRIVATE FUND ADVISERS

All Private Fund Advisers, including SEC-registered and exempt reporting advisers, must comply with the following:

**Restricted Activities Rule.** In contrast to the proposed rules, which largely prohibited the following activities, the Final Rules adopt a disclosure and consent approach to such activities:

- **Investigation Fees.** A Private Fund Adviser cannot charge or allocate to a private fund fees or expenses associated with an investigation of the Private Fund Adviser without disclosing and receiving fund investor consent. If an investigation results (or has resulted) in a court or governmental authority imposing a sanction for a violation of the Advisers Act or its rules on the Private Fund Adviser, no fees and expenses related to that investigation may be charged to the fund.

- **Regulatory, Examination and Compliance Fees.** A Private Fund Adviser cannot charge or allocate to a private fund: (1) regulatory; (2) examination; or (3) compliance fees/expenses of the adviser, unless the adviser discloses such fees and/or expenses to the investors.
- **Non-Pro Rata Portfolio Investment Fees.** A Private Fund Adviser cannot charge or allocate to the private fund fees or expenses related to a portfolio investment on a non-pro rata basis, unless the allocation approach is fair and equitable and the Private Fund Adviser distributes advance written notice of the non-pro rata charge to the investors. The Private Fund Adviser must also include a description of how the allocation is fair and equitable to the investors.
- **Limit on Tax-related Reductions of Clawbacks.** A Private Fund Adviser cannot reduce the amount of a private fund clawback by certain taxes, unless the Adviser discloses the pre-tax and post-tax clawback amounts to the fund investors.
- **No Borrowing from Private Fund Client.** A Private Fund Adviser cannot borrow or receive a credit extension from a private fund client without disclosing and receiving consent from the fund investors.

**Preferential Treatment Rule.** A Private Fund Adviser cannot provide preferential treatment terms to private fund investors regarding: (1) certain redemptions from a private fund, unless applicable law requires the ability to redeem or the Private Fund Adviser offers the same preferential redemption rights to every investor without qualification; and (2) certain preferential information about portfolio holdings or exposures, unless every investor receives an offer of such information. In addition, a Private Fund Adviser cannot provide preferential treatment relating to material economic terms to any investors, unless the Private Fund Adviser discloses such terms to prospective investors before they invest. The Private Fund Adviser must also disclose all preferential terms to every investor following the investor’s investment.

Notably, the commentary to the Final Rules says that to qualify for the disclosure exception to the Preferential Treatment Rule, “an adviser must have offered the same redemption ability to all other existing investors and must continue to offer such redemption ability to all future investors without qualification (e.g., no commitment size, affiliation requirements, or other limitations).”

**Legacy Status.** The SEC is providing legacy status for the prohibitions aspect of the Preferential Treatment Rule and certain 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 discussed below, if the applicable rule would require the parties to amend the agreements. However, such legacy status does not permit Private Fund Advisers to charge for fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Advisers Act or its rules. Additionally, legacy status does not apply to the disclosure portions of the Preferential Treatment Rule because the SEC believes that transparency of these terms is important and will not harm investors in the private

fund. As a result, preferential treatment information in side letters that existed before the compliance date must be disclosed to other investors that invest in a fund post compliance date.

The Quarterly Statement Rule, Private Fund Audit Rule, Adviser-Led Secondaries Rule, Restricted Activities Rule, and Preferential Treatment Rule do not apply to investment advisers with respect to securitized asset funds they advise.

### **Compliance Period for Private Fund Adviser Rules.**

- For the Private Fund Audit Rule and the Quarterly Statement Rule, the compliance date is 18 months after the date of publication of the Final Rules in the Federal Register.
- For the Adviser-Led Secondaries Rule, the Restricted Activities Rule and the Preferential Treatment Rule, the compliance dates are: 12 months after the date of publication in the Federal Register in the case of advisers with \$1.5 billion or more in private fund assets under management; and 18 months after the date of publication in the Federal Register for advisers with less than \$1.5 billion in private funds assets under management.

## **ALL REGISTERED INVESTMENT ADVISERS**

Written Annual Compliance Review Requirement. The Final Rules amend certain compliance rules under the Advisers Act to require **all** registered advisers, **including those that do not advise private funds**, to document, in writing, the required annual review of the adviser's compliance policies and procedures. Advisers will have 60 days to comply with this change after the Final Rule is published in the Federal Register.

### **RELATED PRACTICE AREAS**

- M&A & Corporate Finance
- Securities & Corporate Governance

## MEET THE TEAM



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