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# The New SEC Private Fund Adviser Rules

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# The Private Fund Adviser Rules - Overview

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- On August 23, 2023, the SEC approved new rules that will apply to advisers of private funds.
- The SEC's stated aims:
  - Protect investors who directly or indirectly invest in private funds by increasing visibility into certain practices involving compensation schemes, sales practices, and conflicts of interest through disclosure;
  - Establish requirements to address such practices that have the potential to lead to investor harm; and
  - Restrict practices that are contrary to the public interest and the protection of investors.

# The Private Fund Adviser Rules – Overview (Cont.)

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- The rules:
  - Require RIAs to private funds to provide **transparency** to investors regarding fees and expenses and other terms of their relationship with private fund advisers and the performance of such private funds;
  - Require RIAs to obtain an **annual financial statement audit** of each private fund it advises and, in connection with an **adviser-led secondary transaction**, a **fairness opinion** or **valuation opinion** from an independent opinion provider;
  - Restrict all private fund advisers from engaging in certain **restricted activities** unless they provide specified **disclosure** and, for certain **restricted activities**, obtain consent from investors;
  - Prohibit all private fund advisers from providing certain types of **preferential treatment** that would have a **material, negative effect** on other investors, subject to certain exceptions;
  - Prohibit all private fund investors from providing other types of **preferential treatment** to any investor in a private fund, except if disclosed.
- **“Legacy Status”** is available with respect to certain aspects of the **preferential treatment rule** and **restricted activities rule**.

# Private Fund Adviser Rules

## Agenda

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1. Compliance Timeline
2. Applicability
3. Restricted Activities
4. Preferential Treatment (Liquidity and Transparency)
5. Quarterly Reports
6. Audit Rule
7. Compliance Rule Amendments
8. Adviser-led Secondaries
9. Grandfathering / “Legacy Status”
10. Note on Fiduciary Duties

# Private Fund Adviser Rules

## Compliance Timeline

New Rule	Applicability	General Description	Compliance Date:	
			Larger Private Fund Advisers (AUM ≥ \$1.5 billion)	Smaller Private Fund Advisers (AUM < \$1.5 billion)
<b>Quarterly Statement Rule</b>	Registered private fund advisers only.	Requires the preparation of a quarterly statement that includes certain information regarding fees, expenses and performance.	Friday, March 14, 2025 (18 months from publication)	
<b>Audit Rule</b>	Registered private fund advisers only.	Requires an RIA to cause a private fund to undergo a financial statement audit that meets the requirements of the Custody Rule.	Friday, March 14, 2025 (18 months from publication)	
<b>Adviser-led Secondaries Rule</b>	Registered private fund advisers only.	Requires an RIA conducting an adviser-led secondary transaction with respect to any private fund that it advises to distribute to investors a fairness or valuation opinion and a summary of any material business relationships with the opinion provider.	Saturday, September 14, 2024 (12 months from publication)	Friday, March 14, 2025 (18 months from publication)
<b>Preferential Treatment Rule</b>	All private fund advisers.	Prohibits, with limited grandfathering, certain preferential treatment with respect to redemption terms and information rights. Certain preferential rights are permitted with disclosure.	Saturday, September 14, 2024 (12 months from publication)	Friday, March 14, 2025 (18 months from publication)

Note: For purposes of determining size as a “larger” or “smaller” private fund adviser, advisers should calculate private fund assets under management (in the same manner as for Form PF) as of the last day of the adviser’s most recently-completed fiscal year.

# Private Fund Adviser Rules

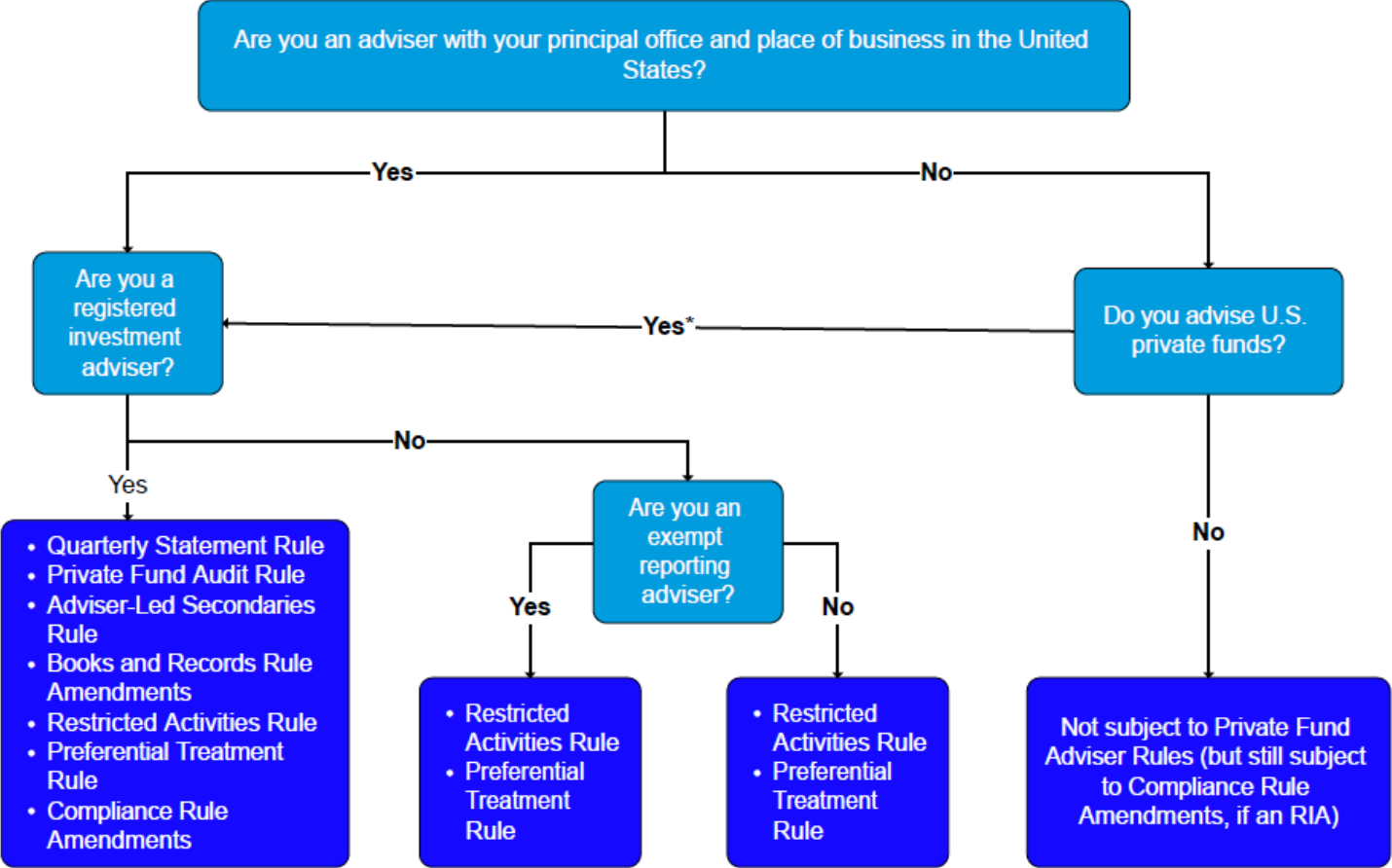
## Compliance Timeline (Cont.)

New Rule	Applicability	General Description	Compliance Date:	
			Larger Private Fund Advisers (AUM ≥ \$1.5 billion)	Smaller Private Fund Advisers (AUM < \$1.5 billion)
<b>Restricted Activities Rule</b>	All private fund advisers.	Restricts, with limited grandfathering, advisers from engaging in certain activities and practices, unless they satisfy specific disclosure and, in certain cases, consent requirements of the rule, including certain non-pro rata fee and expense allocations, reduction of adviser clawback for taxes, regulatory, compliance and examination fees and expenses, investigation fees and expenses, and borrowing or receiving an extension of credit from a client. Investigation fees and expenses prohibited in all cases (no grandfathering, and regardless of disclosure or consent) if adviser is sanctioned for violating the Advisers Act.	Saturday, September 14, 2024 (12 months from publication)	Friday, March 14, 2025 (18 months from publication)
<b>Compliance Rule Amendments</b>	All SEC-registered advisers (whether or not advising private funds).	Requires the documentation of the annual review of an RIA's compliance policies and procedures.	Monday, November 13, 2023 (60 days from publication)	

Note: For purposes of determining size as a “larger” or “smaller” private fund adviser, advisers should calculate private fund assets under management (in the same manner as for Form PF) as of the last day of the adviser’s most recently-completed fiscal year.

# Private Fund Adviser Rules

## Applicability



\* In the Adopting Release, the SEC clarified that the Rules would not apply to an offshore adviser (whether registered or exempt) with respect to any non-U.S. private fund that it advises, even if the fund has U.S. investors, but **would** apply to an offshore adviser with respect to any U.S. private fund that it advises. U.S. advisers, by contrast, are subject to the Rules with respect to **all** private funds they advise (whether U.S. or offshore).

NOTE: The Private Fund Adviser Rules do not apply to investment advisers with respect to "securitized asset funds", private funds whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders (e.g., CLOs).

# Private Fund Adviser Rules

## Restricted Activities Rule

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### General Principle:

- Restricts private fund advisers from engaging in certain activities unless specific disclosures are made and, in some cases, investor consent is obtained.

### Restricts:

- Charging or allocating to a private fund advised by the adviser any **regulatory, compliance or examination-related** fees or expenses of the adviser or its related persons (permitted with **subsequent disclosure**). Disclosure will need to include the dollar amount of what is being charged and itemization (i.e., stating “compliance expenses”, will not suffice).
- Charging or allocating to a private fund advised by the adviser any fees or expenses associated with an **investigation** of the adviser or its related persons by any governmental or regulatory authority (permitted with **informed consent** from investors, but **only if the adviser or its related persons have not been sanctioned** for violations of the Advisers Act).
  - If the investigation results in **sanctions**, allocating such expenses to the fund is **always prohibited** even with disclosure and consent (although pre-Compliance Date agreements may be covered by grandfathering – discussed below).
  - If expenses are approved during the investigation, but the investigation later results in sanctions, the adviser would need to reimburse the fund.



# Private Fund Adviser Rules

## Restricted Activities Rule (Cont.)

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### Restricts:

- Charging or allocating fees and expenses related to a **portfolio investment** on a **non-pro rata** basis when more than one private fund or other client advised by the adviser or its related persons have invested or are proposed to invest.
  - Permitted with **advance disclosure**; any such charge/allocation must describe to investors how it is **fair and equitable under the circumstances**.
  - Consider implications for co-investment vehicles and managed account arrangements.
- Reducing the amount of any **performance compensation clawback** by actual, potential or hypothetical taxes applicable to the adviser, its related persons or their owners.
  - Permitted with **subsequent disclosure**.
  - This could be applicable to hedge funds with that provide for tax distribution in advance of crystallized incentive allocations (multi-year incentive allocation calculations)
- Borrowing, or receiving a loan or extension of credit, from a private fund client.
  - Permitted with “**informed consent**” (adviser must disclose **material** terms).
  - Tax distributions and management fee offsets are not “borrowings”.

# Private Fund Adviser Rules

## Restricted Activities Rule (Cont.)

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### Other Notes:

- Subsequent disclosure of regulatory/compliance expenses and clawback reductions for taxes can be made by way of the quarterly report for RIAs only.
  - But note that, for advisers to funds of funds, the SEC pointed out that the **extended fund-of-funds quarterly statement deadlines** would **not** apply to the requirement to disclose such expenses.

### Key Definitions:

- **Consent:** Written consent from at least a **majority in interest** of the fund’s investors that are **not related persons** of the adviser.
- **Subsequent disclosure:** Disclosure made in writing within 45 days after the end of the fiscal quarter in which the relevant activity occurs.
- **Pro rata basis:** Not defined in the Rules and will require a “facts and circumstances” analysis. Note, pro rata may be on available capital, relative NAV, invested capital or other pro rata methodologies.

# Private Fund Adviser Rules

## Preferential Treatment Rule – Preferential Liquidity

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- Prohibits granting an investor in the private fund or in a **similar pool of assets** the ability to redeem on terms that the adviser reasonably expects to have a **material, negative effect** on other investors in that private fund or **similar pool of assets**.
  - Permitted if required due to **applicable laws, rules, regulations or orders** of any relevant foreign or U.S. governmental or political subdivision to which the investor, the private fund or any similar pool of assets is subject (e.g., ERISA).
    - Note, policies of an investor will not suffice as a withdrawal carve-out. For example, compliance with a State Plan’s pay-to-play policies.
  - Permitted if such rights are offered to **all other existing investors** in the fund and any **similar pool of assets**, and will **continue to be offered** to all future investors in the private fund or **similar pool of assets**.
    - Note, prohibition of preferential liquidity does not only apply to side letter terms, but also different liquidity terms imbedded in series/class a private fund offers.
    - Prohibition on different series/classes will apply where there are any limitations on access to a series/class. For example, size-based conditions, early closer rights and ceasing to offer legacy series/classes.
    - Consider implications for manager/general partner and employee liquidity

# Private Fund Adviser Rules

## Preferential Treatment Rule – Preferential Liquidity (Cont.)

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### Key Definitions:

- **Similar pool of assets:** Pooled investment vehicle that has **similar** investment policies, objectives or strategies to those of the private fund.
  - Likely to include parallel funds and other funds where there is a significant overlap of investments.
  - Carves out registered funds, securitized asset funds (e.g., CLOs, CDOs.) and managed accounts.
  - Consider impact on funds-of-one and managed accounts
- **Material, negative effect:** Not defined in the Rules and will require a “facts and circumstances” analysis.

# Private Fund Adviser Rules

## Preferential Treatment Rule – Preferential Transparency

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- Prohibits 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 if the adviser reasonably expects that providing the information would have a **material, negative effect** on other investors in that private fund or similar pool of assets.
  - Permitted if the adviser **offers** such information to **all other existing investors** in the private fund at the same time or substantially the same time.
  - Preferential transparency rights for investors in an **illiquid fund** will generally not be seen as having a **material, negative effect** on other investors.
    - Note, analysis will turn on whether the information provided will provide an investor information that may assist such investor in exercising a withdrawal/redemption right that other investors do not have
    - Consider review of confidentiality and non-use (or other NDAs) in assessing likelihood that such information may have a material, negative affect on other investors
- Consider implications with respect to investor DDQ reviews, investor meetings, reports to risk aggregation services, etc.

# Private Fund Adviser Rules

## Preferential Treatment Rule – Disclosure of Key Terms

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### Material Economic Terms:

- Requires **advance disclosure** of any preferential treatment related to any **material** economic terms that the adviser or its related persons provide to other investors in the same private fund.
  - Note, material economic terms includes management fees, incentive/carried interest terms, rights to co-investment and liquidity terms.
- Requires **subsequent disclosure** of **other** preferential terms of any kind to all investors in the fund:
  - For **liquid funds**: as soon as reasonably practicable following the investor's investment in the private fund.
  - For **illiquid funds**: as soon as reasonably practicable following the end of the private fund's fundraising period.
- Requires annual notices of any preferential terms granted since the most recent prior notice.

# Private Fund Adviser Rules

## Quarterly Reports

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Requires RIAs to provide **quarterly statements** (in plain English) to private fund investors, including:

- **Fund table** (expenses paid by fund):
  - A detailed accounting of all **compensation, fees and other amounts** allocated or paid **to the adviser or any of its related persons** during the reporting period **by the private fund**;
    - **separate line items** for each category of allocation or payment (e.g., management, advisory, sub-advisory or similar fees or payments, performance-based compensation, but also loan administration)
    - reflecting the **total dollar amount**;
  - A detailed accounting of all **fees and expenses** allocated to or paid by the private fund during the reporting period, with **separate line items** for each category of fee or expense reflecting the **total dollar amount** (e.g., organizational, accounting, legal, administration, audit, tax, due diligence, travel fees and expenses, etc.); and
  - The amount of any **offsets** or **rebates** carried forward during the reporting period to subsequent periods to reduce **future payments or allocations** to the **adviser or its related persons**.

# Private Fund Adviser Rules

## Quarterly Reports (Cont.)

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- **Portfolio investment table:** A separate table in the quarterly reports describing payments by **covered portfolio investments** :
  - Detailed accounting of all portfolio investment compensation allocated or paid to the adviser or any of its related persons by the **covered portfolio investment** during the reporting period, with **separate line items** for each category of allocation or payment reflecting the **total dollar amount**, presented both **before** and **after** the application of any **offsets, rebates or waivers**.
- Calculations and cross references:
  - Must include prominent disclosure regarding the manner in which all expenses, payments, allocations, rebates, waivers and offsets are calculated;
  - Must include **cross references** to the sections of the fund’s organizational and offering documents that set forth the applicable **calculation methodology**.

### Key Definitions:

- **Covered portfolio investment:** A portfolio investment that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period.



# Private Fund Adviser Rules

## Quarterly Reports (Cont.)

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- **Liquid funds** must provide:
  - (i) **annual net total returns** for **each fiscal year** over the past 10 fiscal years or since inception, whichever is shorter;
  - (ii) **average annual net total returns** over **one, five, and ten-year** fiscal periods; and
  - (iii) the **cumulative net total return for the current fiscal year** as of the most recent financial quarter covered by the statement.
- **Illiquid funds (funds that are not required to redeem interests upon request)** must provide, from inception:
  - (i) **gross and net IRR**;
  - (ii) **gross and net MOIC**;
  - (iii) **gross IRR** and **gross MOIC** for the **realized and unrealized portion** of the illiquid fund's portfolio, with the realized and unrealized performance shown separately;
  - (iv) a statement of all contributions and distributions;
  - Both levered and unlevered returns must be shown.

# Private Fund Adviser Rules

## Quarterly Reports (Cont.)

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- Must provide consolidated reporting for **similar pools of assets** if that provides **more meaningful information**.
- Statements must be delivered within **45 days** of the end of the quarter for Q1 - Q3, and within **90 days** of the end of the quarter for Q4.
  - For **funds of funds**, statements must be delivered within **75 days** of the end of the quarter for Q1-Q3, and within **120** days of the end of the quarter for Q4.
- Newly-formed funds must comply after the **second full fiscal quarter** of generating operating results.
- Key Question: How should the performance of **side pocket** investments be calculated and reported?
  - No guidance, so combine side pocket performance with main fund?

# Private Fund Adviser Rules

## Audit Rule

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- Requires RIAs to ensure that each fund undergoes an annual financial statement audit.
  - Audit must adhere to the same standards as the Custody Rule’s audit requirements.
  - Requires such audits be done annually within **120 days** of the private fund’s fiscal year-end and promptly upon liquidation. All of the Custody Rule provisions and guidance relating to audits apply here as well, including the **180-day** timeframe afforded to fund-of-funds.
  - If the adviser is an unaffiliated sub-adviser, the adviser must take **all reasonable steps** to cause the fund to undergo an audit that meets the Custody Rule requirements.
- Effectively **eliminates** the option of a surprise examination.
- What if a fund is in **wind-down**?
  - Some potential solutions include liquidating trusts with an unaffiliated trustee or otherwise selling off positions.
- Note: The SEC recently proposed to amend and redesignate the custody rule as well, and is continuing to consider comments received in response to that proposal.

# Private Fund Adviser Rules

## Compliance Rule Amendments

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- The existing Compliance Rule has been amended to require **all** RIAs (including those that do not advise private funds) to document in writing the required annual review of their compliance policies and procedures.
- This rule is effective within **60 days** of publication in the federal register, or Monday, November 13, 2023.

# Private Fund Adviser Rules

## Adviser-led Secondaries Rule

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- Requires an RIA, prior to the due date of the election form for an adviser-led secondary transaction, to:
  - Obtain and distribute a **fairness opinion** or **valuation opinion** from an independent opinion provider; and
  - Prepare and distribute a written summary of any material business relationships the adviser or any of its related persons have, or have had, within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider.
- In the hedge fund context, consider implications with respect to a fund restructuring.

### Key Definition:

- **Adviser-led secondary transaction:** any transaction initiated by the investment adviser or any of its related persons that offers private fund investors the choice between:
  - (1) Selling all or a portion of their interests in the private fund; and
  - (2) Converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

# Private Fund Adviser Rules

## Grandfathering / “Legacy Status”

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- The **Restricted Activities Rule** and **Preferential Treatment Rule** provide for **grandfathering** with respect to certain of the Rules’ provisions for “**legacy**” **contractual agreements** that govern the fund or that govern any borrowing, loan, or extension of credit entered into by a fund, if the agreements both (i) were entered into **prior to the Compliance Date** and (ii) would **need to be amended** in order to ensure compliance with the rules.
  - Legacy agreements relating to a fund bearing investigation-related expenses, or to the adviser borrowing from a fund, are grandfathered without the need to obtain investor consent,
    - Agreements permitting a fund to bear expenses related to sanctioned matters are not permitted.
  - Legacy **preferential redemption** or **information rights** are grandfathered without a need to offer them to other investors.
    - **However, grandfathered terms must be disclosed pursuant to the notice provisions.**

# Private Fund Adviser Rules

## Fiduciary Duties

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- The SEC had initially proposed to prohibit an adviser to a private fund from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or investors for a **breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness** in providing services to the private fund.
- Instead of adopting this proposal, the SEC in the Adopting Release clarified that the following actions could be contrary to an adviser's fiduciary duties:
  - Charging monitoring, servicing, and other fees for services that are not performed; and
  - Waivers of fiduciary duties under federal securities laws.
- Advisers should continue to consider their fiduciary duties to their clients, an ongoing examination point from the SEC's perspective.

# Final Thoughts

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- The application of the new rules may vary from adviser to adviser, and from fund to fund, based on the facts and circumstances of each situation.
- On Friday, Sept. 1, 2023, a lawsuit was filed with the federal Court of Appeals in the Fifth Circuit challenging the validity and enforceability of the rules.
  - The filing does not automatically pause the rules’ transition periods or otherwise delay their compliance dates.
  - A stay of the rules may be requested or granted, either by court order or as otherwise determined by the SEC.
- Petitioners recently filed a motion to expedite the proceeding, which the SEC is not contesting, proposing a schedule that would result in a final ruling by May 31, 2024. The Court has agreed to expedited treatment, and to some of the proposed briefing deadlines, but has not yet agreed as to a final ruling date.
  - Given the short period of time between May 31 and the Compliance Dates, most advisers (particularly “larger” private fund advisers) may be badly disadvantaged by taking a “wait and see” approach.
  - That would not leave much time to prepare for compliance should the Court ultimately uphold the Rules, even if the litigation were to proceed on the proposed timeframe.



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## Education

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Robert Sutton is a partner of the Private Funds Group and a member of the Corporate Department. He is a seasoned practitioner with over 20 years of experience counseling managers and advisers of private funds on regulatory matters, as well as regulatory issues related to the formation and operation of private equity, credit, real estate, infrastructure, hedge and other private funds.

Rob has a deep knowledge of the market practice of asset managers and in particular, as it relates to Advisers Act-related issues. From some of the largest and most sophisticated firms in the global asset management industry to start-ups and mid-sized firms, Rob's experience includes a wide spectrum of funds and asset classes across their life cycles. Rob regularly advises on matters in connection with: U.S. investment adviser registration and regulation; Advisers Act and other U.S. securities law issues relating to the formation, marketing and offering of private funds; Identifying and managing conflicts of interest, and addressing related Advisers Act risks, SEC examinations, and exam readiness preparation; Design and implementation of investment adviser compliance policies and procedures; U.S. regulatory issues relating to purchases and sales of investment advisory businesses (minority stake and control stake transactions, buy-side and sell-side representations); Advisers Act and other U.S. regulatory issues relating to private fund restructurings and recapitalizations, strip sales, continuation fund formations and similar transactions; Advisers Act issues relating to the formation of SPACs by investment advisers; and, Investment Company Act status analyses of private fund structures, investment transaction structures and other non-registered investment company structures.

Rob has been recognized by his clients and peers for his extraordinary work, gaining various accolades including mentions in preeminent directories such as The Legal 500. He is also very active within the private funds industry, contributing to numerous publications and collaborating on several speaking engagements.

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