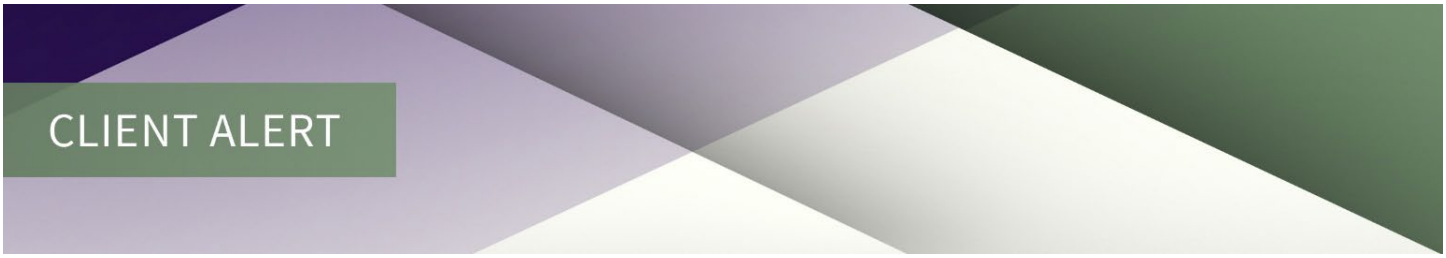

SEC Adopts Major Rule Changes for Private Fund Advisers

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On Wednesday, the Securities and Exchange Commission (the "SEC") adopted new rules under the Investment Advisers Act of 1940 (the "Advisers Act").[1] These rules and amendments (the "Final Rules") substantially modify several existing regulatory requirements and create significant new obligations for investment advisers to private funds. According to the SEC, the Final Rules are intended to increase private fund investor protections by: (i) providing more transparency; (ii) imposing additional limits on conflicts of interest; and (iii) requiring additional governance mechanisms for client disclosure, consent, and oversight.[2]

The Final Rules also include an amendment to the Compliance Rule, Rule 206(4)-7 under the Advisers Act. The amendment will require all registered advisers, including those that do not advise private funds, to document in writing the required annual review of their compliance policies and procedures.

1 *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 6383 (Aug. 23, 2023) (the "Adopting Release"), available here.

2 *See* Adopting Release at 16.

This alert briefly summarizes the Final Rules, some key changes from the proposed rules, and the compliance dates for the Final Rules.[3] We are carefully reviewing the rules and intend to provide an in-depth alert assessing the Final Rules and the implications for private fund advisers.

I. Final Rules Applicable to Registered Investment Advisers to Private Funds

The Final Rules will require private fund advisers that are registered with the SEC or required to be registered with the SEC to comply with the following requirements: (a) provide quarterly statements to investors; (b) obtain and deliver to private fund investors an annual audit of the private fund's financial statements; and (c) obtain and deliver an independent fairness opinion or valuation opinion and provide certain other disclosures in connection with an adviser-led secondary transaction.

a. *Quarterly Statement Rule*

The Final Rules require registered private fund advisers to distribute a quarterly statement to private fund investors covering fund-level information regarding performance, the cost of investing in the private fund, fees and expenses paid by the private fund, and certain compensation and other amounts paid to the adviser.

Key changes from the Proposed Rules include: (i) requiring registered advisers to illiquid funds to calculate performance information with and without the impact of subscription facilities, rather than only without; (ii) defining "illiquid fund" to be based primarily on withdrawal and redemption capability instead of all six of the factors included in the proposal; (iii) requiring registered advisers to present liquid fund performance only for a 10-year period, rather than since inception; and (iv) expanding from 45 days to 90 days the time period for registered advisers to deliver fourth quarter statements to investors (registered advisers to funds of funds are granted an additional 30 days to deliver quarterly statements).

b. ***Private Fund Audit Rule***

Registered private fund advisers will also be obligated to require private funds they advise (other than securitized asset funds) to undergo a financial statement audit that meets the requirements of the audit provision under the existing Custody Rule, Rule 206(4)-2 under the Advisers Act, and to deliver the audited financial statements to investors in accordance with the Custody Rule.[4]

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[3] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 5955 (Feb. 9, 2022), 87 Fed. Reg. 16886 (Mar. 24, 2022) (the "Proposed Rules"), available here and here. Our client alert discussing the Proposed Rules is available here.

[4] . The SEC reopened the comment period on its recently proposed amendments to the Custody Rule in light of the adoption of the Final Rules. *See SEC Reopens Comment Period for Enhanced Safeguarding Rule for Registered Investment Advisers Proposal*, Press Release 2023-156 (Aug. 23, 2023), available here, *See also Safeguarding Client Advisory Assets*, Investment Advisers Act Release No. 6384 (Aug. 23, 2023), available here.

c. ***Adviser-Led Secondaries Rule***

Registered private fund advisers will be required to obtain either a fairness opinion or a valuation opinion from an independent opinion provider when conducting an adviser-led secondary transaction. This represents more flexibility for advisers than the Proposed Rules, which would have required advisers to obtain a fairness opinion, rather than an option between a fairness or valuation opinion. The Final Rules also will require an adviser to prepare and distribute to private fund investors a summary of any material business relationships the adviser has, or has had within the prior two years, with the independent opinion provider.

II. Final Rules Applicable to All Advisers to Private Funds

Certain of the Final Rules apply to all investment advisers to private funds, regardless of whether an adviser is registered, or required to be registered, with the SEC. The Final Rules will require all private fund advisers to comply with (a) the restricted activities rule and (b) the preferential treatment rule.

a. ***Restricted Activities Rule***

All private fund advisers will be restricted from engaging in the following activities:

- Charging or allocating fees or expenses associated with an investigation of the adviser by any governmental or regulatory authority to a private fund without disclosure to all private fund investors and written consent from a majority in interest of the private fund investors;
- Charging 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 the rules promulgated thereunder to a private fund. Importantly, this prohibition is not covered by the legacy status provision described below;
- Charging or allocating regulatory, examination, or compliance fees or expenses of the adviser or its related persons to a private fund, unless such fees and expenses, including the dollar amount, are disclosed to investors within 45 days of the quarter in which the charge occurs;
- Reducing the amount of an adviser clawback by the amount of any taxes actually or potentially applicable to the adviser or its related persons, unless the adviser discloses the dollar amount of the pre-tax and post-tax clawback amount to private fund investors within 45 days after the end of a quarter in which the clawback occurs;
- Charging or allocating fees or expenses related to a portfolio investment on a non-pro rata basis to a private fund, unless the allocation approach is fair and equitable and the adviser distributes to investors advance written notice

of the non-pro rata charge and a description of how the allocation approach is fair and equitable under the circumstances; and

- Borrowing or receiving an extension of credit from a private fund client without disclosure to all private fund investors and written consent from a majority in interest of the private fund investors.

In a departure from the Proposed Rules, the Final Rules only restrict these activities, rather than prohibit them, if the adviser provides sufficient disclosures, and in some cases, obtains client consent. In addition, unlike the Proposed Rules, the Final Rules do not include a prohibition on fees for unperformed services and do not include a prohibition on seeking indemnification from private fund investors where the adviser acted negligently.

The Final Rules include a "legacy status" provision clarifying that the restricted activities rule does not apply to contractual agreements governing a private fund that commenced operations as of the compliance date, and which were entered into in writing prior to the compliance date, if the restrictions would require the parties to amend the governing agreements of the relevant private fund.

b. *Preferential Treatment Rule*

All advisers to private funds (except securitized asset funds) will be prohibited from providing preferential redemption terms to investors in a private fund or a similar pool of assets, if the adviser reasonably expects (at the time granted) that the preferential redemption terms will have a material, negative effect on other investors in the private fund or similar pool of assets. In a change from the Proposed Rules, this restriction does not apply if the ability to redeem is required by applicable law or the adviser offers the preferential redemption rights to all other investors without qualification. In a notable change from the Proposed Rules, the Adopting Release explicitly provides that this restriction applies to preferential redemption terms included in a private fund's governing documents.[5]

The Final Rules also will restrict private fund advisers (except advisers to securitized asset funds) from providing investors with preferential information rights about portfolio holdings or exposures, if the adviser reasonably expects (at the time such rights are granted) that providing such information will have a material, negative effect on other investors in the private fund or similar pool of assets, unless such preferential information is offered to all investors at the same or substantially the same time.

Similar to the restricted activities rule discussed above, the Final Rules provide "legacy status" for preferential redemption terms and preferential information rights. Legacy status will apply to contractual agreements governing a private fund that

[5] *See* Adopting Release at 278-79.

commenced operations as of the compliance date and that were entered into in writing prior to the compliance date, if the restrictions would require the parties to amend the governing agreements of the relevant private fund.

In addition, all private fund advisers (except advisers to securitized asset funds) will be prohibited from providing any other preferential treatment to investors, unless the adviser discloses in writing to each prospective private fund investor, in advance of an investor's investment in the private fund, information regarding any preferential treatment related to any material economic terms provided to other investors. The adviser also will be required to disclose all preferential treatment provided to investors in a written notice to current investors in the private fund after an illiquid fund's fundraising period or, for a liquid fund, following the investor's investment in the fund, and thereafter on an annual basis. This requirement is not subject to the "legacy status" provision.

III. Effective Date and Compliance Period

The Final Rules will be effective 60 days after publication in the Federal Register. The compliance date for the private fund audit rule and the quarterly statement rule 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, compliance dates vary, with advisers having $1.5 billion or more in private fund assets under management subject to a 12-month compliance date and advisers with less than $1.5 billion in private fund assets under management subject to an 18-month compliance date. Notably, compliance with the requirement to document in writing an adviser's annual compliance review will be required 60 days after publication in the Federal Register.

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