STRADLEY RONON

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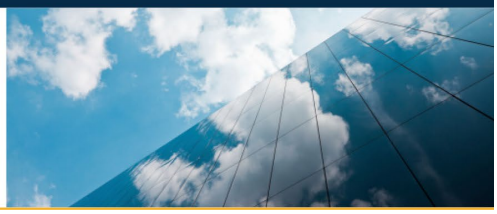
**Client Alert** | Investment Management



# The SEC Adopts Sweeping Private Fund Adviser Reforms

On Aug. 23, 2023, the U.S. Securities and Exchange Commission (SEC), in a 3-2 vote, adopted new rules under the Investment Advisers Act of 1940 (Advisers Act) that will have a sweeping impact on investment advisers of private funds.[1] This alert summarizes the adopted rules and highlights some key observations and issues for investment advisers to consider.

**Key observations:**

- The SEC dropped the proposed general prohibition on hedge clauses (i.e., waiver or indemnification provisions) but clarified that an adviser seeking reimbursement, indemnification or exculpation for breaching its federal fiduciary duty would violate the antifraud provisions of the Advisers Act.
- The SEC also dropped the proposed prohibition on charging a portfolio investment for certain fees and will permit other activity that was proposed to be prohibited subject to certain disclosure or consent.
- The SEC added an exception to the definition of "private fund" for "securitized asset funds," which generally include collateralized loan obligations (CLOs). Thus, advisers do not have to comply with the quarterly statement, audit, preferential treatment and restricted activity rules (as described below) with respect to securitized asset funds.
- On Sept. 1, 2023, industry trade groups filed a challenge to the rules in the United States Court of Appeals for the Fifth Circuit.[2]

## Registered Private Fund Advisers

### Quarterly Statements Rule

New Rule 211(h)(1)-2 under the Advisers Act (Quarterly Statements Rule) requires an investment adviser that is registered or required to be registered with the SEC to prepare a quarterly statement for any private fund (other than a securitized asset fund) that it advises, directly or indirectly, that has at least two full fiscal quarters of operating results. The Quarterly

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Investment Advisers Act Release No. 6383 (Aug. 23, 2023), *available at* https://www.federalregister.gov/d/2023-18660 [hereinafter the Adopting Release].

[2] *See* National Association of Private Fund Managers v. Sec. and Exch. Comm'n, No. 23-60471 (5th Cir. filed Sept. 1, 2023), *available at* https://www.managedfunds.org/wp-content/uploads/2023/09/MFA-Filing.pdf. In particular, echoing Commissioner Peirce's dissenting statement to the rulemaking, petitioners allege that "The Commission's claimed discovery of a sweeping new power over private funds – in either a general antifraud provision (section 206(4) of the Advisers Act) or a statutory section that does not mention private funds, and that is focused on retail investors (section 913 of the Dodd-Frank Act) – is not plausible."

Statements Rule requires registered private fund advisers to distribute a quarterly statement to private fund investors that discloses fund-level information regarding performance, the cost of investing in the private fund, and fees and expenses paid by the private fund, as well as certain compensation and other amounts paid to the adviser.

*Fee and Expense Disclosure* – The following table summarizes the fund-level and portfolio investment-level fee and expense reporting requirements.

| **Fund-Level Disclosure** | |
|---|---|
| **Adviser Compensation** | ▪ Management, advisory, sub-advisory or similar fees or payments, and performance-based compensation.<br>▪ Compensation, fees and other amounts allocated or paid to the adviser's related persons. |
| **Fund Fees and Expenses** | ▪ Detailed accounting of all fees and expenses allocated to be paid by the fund, other than those disclosed as adviser compensation.<br>○ If a fund expense also could be characterized as adviser compensation, such payment or allocation must be disclosed as adviser compensation as opposed to a fund expense. |
| **Offsets, Rebates and Waivers** | ▪ Adviser compensation and fund expenses must reflect amounts both before and after the application of any offsets, rebates or waivers.<br>▪ Any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future adviser compensation must be reported. |
| **Portfolio Investment-Level Disclosure**[3] | |
| **Portfolio Investment Compensation** | ▪ Detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment, with separate line items for each category of allocation or payment reflecting the total dollar amount.<br>▪ Identity of each covered portfolio investment to the extent necessary for an investor to understand the nature of the potential or actual conflicts associated with such payments. To the extent the identity of any covered portfolio investment is not necessary for an investor to understand the nature of the conflict, advisers may use consistent code names.<br>▪ List the amount of portfolio investment compensation allocated or paid with respect to each covered portfolio investment both before and after the application of any offsets, rebates or waivers, including the aggregate dollar amount attributable to the fund's interest before and after any such reduction for the reporting period, the amount of any portfolio investment company initially charged, and the amount ultimately retained at the expense of the fund and its investors. |

[3] The SEC proposed a requirement that the portfolio investment table include a list of the fund's ownership percentage of each covered portfolio investment, but the provision was not adopted. *See* Adopting Release at 91.

*Performance Disclosure* – The Quarterly Statements Rule requires advisers to include standardized fund performance information in each quarterly statement provided to fund investors, which differs based on whether the disclosure relates to a "liquid" or "illiquid" private fund.[4]

Liquid fund advisers must disclose the following performance measures in the quarterly statement:

- Annual net total returns since inception or for each fiscal year over the 10 years prior to the quarterly statement, whichever is shorter.
- Each liquid fund's average annual net total returns over the one-, five- and 10-year periods.
- The liquid fund's cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.

**Practice Point: Advisers should generally consider whether they need to periodically revisit the liquid/illiquid determination based on changes in the fund.**

Illiquid fund advisers must disclose the following performance measures in the quarterly statement, shown since the inception of the illiquid fund and computed with and without the impact of any fund-level subscription facilities:

- Gross internal rate of return and gross multiple of invested capital for the illiquid fund.
- Net internal rate of return and net multiple of invested capital for the illiquid fund.
- Gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.

Illiquid fund advisers must also provide investors with a statement of contributions and distributions for the fund, reflecting the aggregate cash inflows from investors and the aggregate cash outflows from the fund to investors, along with the fund's net asset value. Further, the Quarterly Statements Rule requires illiquid fund advisers to display the different categories of required performance information with equal prominence.

*Preparation and Distribution of Quarterly Statements* – The Quarterly Statements Rule requires statements to be distributed to investors within the following timelines:

- For funds that are not fund of funds, quarterly statements must be distributed within 45 days after the end of each of the first three quarters of each fiscal year and within 90 days after the end of the fiscal year.
- For funds that are fund of funds, quarterly statements must be distributed within 75 days after the end of the first three quarters and within 120 days after the end of the fiscal year.

[4] Adopting Release at 104. The SEC defined an "illiquid fund" "as a private fund that (i) is not required to redeem interests upon an investor's request and (ii) has limited opportunities, if any, for investors to withdraw before termination of the fund." A "liquid fund" is any fund that is not an illiquid fund.

- Newly formed funds are required to prepare and distribute a quarterly statement beginning after the fund's second full quarter of generating operating results.

**Audit Rule**

New Rule 206(4)-10 under the Advisers Act (Audit Rule) requires a registered investment adviser providing investment advice, directly or indirectly, to a private fund to cause that fund to undergo a financial statement audit that meets various requirements set forth in Rule 206(4)-2 (*i.e.*, the Custody Rule). As a result, each of the following is required under the Audit Rule:

- The audit must be performed by an independent public accountant that meets the standards of independence set out in Regulation S-X and is registered with, and subject to regular inspection as of the commencement of the professional engagement period as of each calendar year-end, by the Public Company Accounting Oversight Board in accordance with its rules.
- The audit must meet the definition of audit in Regulation S-X.
- Audited financial statements must be prepared in accordance with generally accepted accounting principles.
- Annually, within 120 days of the fund's fiscal year-end and promptly upon liquidation, the fund's audited financial statements (consisting of the applicable financial statements, related schedules and accompanying footnotes and the audit report) are to be delivered to investors in the fund.

***Did you know?*** **In a change from the proposal, the Audit Rule does not contain a notification requirement. However, the SEC recently proposed amendments to the Custody Rule that would require advisers to enter into a written agreement with the independent public accountant performing the audit to notify the SEC within one business day upon issuing an audit report to the entity that contains a modified opinion and within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.**

**Adviser-Led Secondaries Rule**

New Rule 211(h)(2)-2 under the Advisers Act (Adviser-Led Secondaries Rule) requires SEC-registered advisers to satisfy certain requirements if they initiate a transaction that offers the fund's investors the choice between selling all or a portion of their interests in the fund and converting or exchanging all or a portion of their interests in the fund for interests in another vehicle advised by the adviser or any of its related persons (i.e., an adviser-led secondary transaction). To complete an adviser-led secondary transaction, advisers must either obtain a written opinion stating that the price being offered to the fund for any assets being sold as part of an adviser-led secondary transaction is fair (Fairness Opinion), or obtain a written opinion stating the value (as a single amount or a range) of any assets being sold (Valuation Opinion).

Each Fairness Opinion and Valuation Opinion must be provided by an independent opinion adviser – a person who provides fairness opinions or valuation opinions in the ordinary course of its business and is not a related person of the adviser.[5]

## All Private Fund Advisers

### Restricted Activities Rule

New Rule 211(h)(2)-1 under the Advisers Act (Restricted Activities Rule) restricts all advisers to a private fund, regardless of their SEC registration status, from engaging in certain activities. The following chart describes those restrictions and any applicable exceptions.

| | Prohibited Activity | Exception |
|---|---|---|
| **Regulatory, Compliance and Examination Expenses** | Advisers may not charge the fund for regulatory and compliance fees and expenses of the adviser or its related persons and fees and expenses associated with an examination of the adviser or its related persons by any governmental or regulatory authority. | An adviser may charge these fees if the adviser distributes a written notice of any such fees or expenses, and the dollar amount thereof, to investors in writing on at least a quarterly basis. |
| **Reducing Adviser Clawbacks for Taxes** | Advisers may not reduce the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons or their respective owners or interest holders. | An adviser may reduce the amount of a clawback if the adviser distributes to the investors a written notice of the impacted fund that sets forth the aggregate dollar amounts of the clawback both before and after any such reduction of the clawback for actual, potential or hypothetical taxes within 45 days after the end of the fiscal quarter in which the clawback occurs. An adviser must distribute to the investors a written notice of the affected fund that sets forth the aggregate dollar amounts of the clawback both before and after the application of any tax reduction. The aggregate dollar amounts should reflect the gross amount of excess compensation received by the adviser that is being clawed back. |

[5] Advisers must include a written summary of any material business relationships the adviser or any of its related persons has or has had with the independent opinion provider within the two-year period immediately prior to the issuance of the opinion.

| | Prohibited Activity | Exception |
|---|---|---|
| **Certain Non-Pro Rata Fee and Expense Allocations** | Advisers may not directly or indirectly charge or allocate fees and expenses related to a portfolio investment on a non-pro rata basis when multiple funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment. | An adviser may engage in a non-pro rata fee and expense allocation if the non-pro rata charge or allocation is fair and equitable under the circumstances and prior to charging or allocating such fees or expenses to a fund, the investment adviser distributes to each investor a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances. Advisers should consider addressing relevant factors, which might include the adviser's allocation approach and the reason(s) why the adviser believes that its non-pro rata allocation approach is fair and equitable under the circumstances. |
| **Investigation Expenses** | An adviser may not charge the fund for fees and expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority. | An adviser may charge a fund for such fees if an adviser seeks consent from all investors of the fund and obtains written consent from at least a majority in the interest of the fund's investors that are not related persons of the adviser. This exception does not apply to 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 rules promulgated thereunder. |

| | Prohibited Activity | Exception |
|---|---|---|
| **Borrowing** | An adviser may not directly or indirectly borrow money, securities or other fund assets, or receive a loan or an extension of credit, from a fund. | An adviser may engage in such borrowing if the adviser distributes a written notice and description of the material terms of the borrowing to the investors, seeks their consent for the borrowing and obtains written consent from at least a majority in interest of the fund's investors that are not related persons of the adviser. The Restricted Activities Rule does not enumerate specific terms of the borrowing that must be disclosed in connection with an adviser's consent request; rather, it requires advisers to disclose the prospective borrowing and the material terms related thereto. To satisfy an adviser's fiduciary duty, an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest that might incline an investment adviser to provide advice that is not disinterested. The disclosure should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision on whether to provide consent. This restriction does not apply to borrowings from a third party on the fund's behalf or to the adviser's borrowings from individual investors outside of the fund. |

**Preferential Treatment Rule**

New Rule 211(h)(2)-3 under the Advisers Act (Preferential Treatment Rule) prohibits advisers from granting certain preferential redemption rights to private fund investors. The following chart describes those restrictions and any applicable exceptions.

| Prohibited Activity | Exception |
|---|---|
| Advisers may not, directly or indirectly, grant an investor in the fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in the fund or in a substantially similar pool of assets. | An adviser is not prohibited from offering preferential redemption rights if the investor is required to redeem its interest due to applicable laws, rules, regulations or orders of any relevant governing body to which the investor, fund or any similar pool of assets is subject. An adviser is not prohibited from offering preferential redemption rights if the adviser has offered the same redemption ability to all other existing investors and will continue to offer such redemption ability to all future investors in the same fund or any similar pool of assets. |

| Prohibited Activity | Exception |
|---|---|
| Advisers and related persons may not provide information regarding the portfolio holdings or exposures of the fund or of a substantially similar pool of assets 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 in a substantially similar pool of assets. | An adviser is not prohibited from providing preferential information if the adviser offers such information to all existing investors in the fund and any similar pool of assets at the same time or substantially at the same time. |
| Advisers may not, directly or indirectly, provide any preferential treatment to any investor in the fund. | An adviser is not prohibited from providing preferential treatment if the adviser provides each prospective investor in the fund, prior to the investor's investment in the fund, a written notice that provides specific information regarding any preferential treatment related to any material economic terms that the adviser or its related persons provide to other investors in the same fund. An adviser is not prohibited from providing preferential treatment if the adviser distributes to current investors written disclosure of all preferential treatment the adviser or its related persons have provided to other investors in the same fund. Additionally, on at least an annual basis, an adviser must provide a written notice that includes specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same fund since the last written notice provided. |

For prospective investors, notice of preferential treatment must be provided in writing prior to the investor's investment in the fund. For a current investor, the adviser must distribute the notice as soon as reasonably practicable after the end of the fund's fundraising period (for illiquid funds) or following the investor's investment in the fund (for liquid funds).

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. These legacy status provisions apply to governing agreements that were entered into prior to the compliance date (discussed below) if either the Preferential Treatment Rule or the Restricted Activities Rule would require the parties to amend the agreements. However, as noted in the Adopting Release, such legacy status does not permit 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 the rules promulgated thereunder.

## All Registered Advisers

### Compliance Rule

The SEC adopted amendments to Rule 206(4)-7(b) (Compliance Rule) to require all SEC-registered advisers, not just private fund advisers, to document the annual review of their compliance policies and procedures in writing.

**Books and Records**

The SEC amended Rule 204-2 under the Advisers Act to require advisers to retain books and records related to the Quarterly Statements Rule, Audit Rule, Adviser-Led Secondaries Rule, Preferential Treatment Rule, Restricted Activities Rule and Compliance Rule. As with many recent rulemakings, these amendments are designed in part to help staff in the SEC's Examinations Office assess whether advisers are in compliance with the rules.

**Compliance Dates**

| Rule | Advisers With $1.5 Billion or More in Private Funds AUM | Advisers With Less Than $1.5 Billion in Private Funds AUM |
|---|---|---|
| **Compliance Rule** | November 13, 2023 | |
| **Quarterly Statements Rule** | March 14, 2025 | |
| **Audit Rule** | March 14, 2025 | |
| **Restricted Activities Rule** | September 16, 2024 | March 14, 2025 |
| **Adviser-Led Secondaries Rule** | September 16, 2024 | March 14, 2025 |
| **Preferential Treatment Rule** | September 16, 2024 | March 14, 2025 |

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