

Deciphering the Overhauled SEC Rules for the Private Fund Industry – What Advisers Need to Know

Legal Alert
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On August 23, 2023, the U.S. Securities and Exchange Commission (the “**SEC**”) by a 3-2 vote adopted final rules (the “**Final Rules**”) under the Investment Advisers Act of 1940, as amended (the “**Advisers Act**”), which modify certain aspects of the rules initially proposed on February 9, 2022 (the “**Proposed Rules**”) and adopt others largely as proposed. The Final Rules reflect the SEC’s goal of bringing “transparency” to private funds and their sponsors by restricting or requiring extensive disclosure of preferential treatment granted in side letters, as well as imposing numerous additional reporting and other compliance requirements.

Advisers should familiarize themselves with the nuances of the new requirements to ensure compliance. This Legal Alert breaks down FAQs pertaining to the regulations and highlights the most significant obligations established by the adoption of the Final Rules.

Who is affected by the Final Rules, and who is exempt?

The Final Rules apply to varying degrees to both registered private fund advisers and private fund advisers that are exempt from registration under the Advisers Act, as well as advisers that are registered but do not advise private funds.

The Final Rules contain important exceptions for investment advisers to “securitized asset funds” – i.e., private funds whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders. Advisers to these funds are not subject to any of the requirements of the new rules.

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What is the effect of the Final Rules on SEC-Registered Private Fund Advisers?

Quarterly Statement Rule. The Final Rules require SEC-registered private fund advisers to provide investors with quarterly statements containing information about private fund fees, expenses and performance, as well as compensation received from funds and their portfolio companies.

Fund advisers must deliver highly detailed quarterly statements to all investors in their funds within 45 days after the end of Q1, Q2 and Q3 and within 90 days for the end of Q4. The statements must comply with specific formatting and disclosure requirements.

The quarterly statements must disclose private fund fees and expenses in a table format that includes the following information:

1. a detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or its related persons by the private fund during the reporting period;
2. a detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period other than those disclosed in clause (1) (including organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses); and
3. the amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce payments or allocations to the adviser or its related persons.

In addition to fees and expenses, the quarterly statements rule requires private fund advisers to include standardized private fund performance information in each report.

The rule differentiates between liquid and illiquid private funds. Illiquid private funds are generally defined as private funds that do not have to redeem investors' interests upon request and provide limited opportunities, if any, for investors to withdraw before termination of the fund. Liquid private funds, by contrast, are defined as every other type of private fund.

Annual Audit Rule. The Final Rules mandate that SEC-registered private fund advisers conduct annual audits of each private fund they manage (other than a securitized asset fund). These audits must comply with the same standards as the "custody rule" (Rule 206(4)-2 under the Advisers Act) requirements and be conducted by an independent public accountant that is registered and subject to regular inspection by the Public Company Accounting Oversight Board (PCAOB).

What is the effect of the Final Rules on all private fund advisers (registered or not)?

Preferential Treatment Rule. All private fund advisers, whether registered or not (including their related persons), are prohibited under Final Rule 211(h)(2)-3 (the “**preferential treatment rule**”) from providing preferential treatment to investors with respect to redemption rights and certain information rights that the adviser reasonably expects would have a material, negative effect on other investors. The adviser is prohibited from granting an investor the ability to redeem its interests in the private fund or similar pool of assets, except in two instances:

1. if the ability to redeem is required by applicable law, or
2. if the adviser offers the same ability to redeem to all other existing investors in the private fund or similar pool of assets, and will continue to offer this right to all future investors in the private fund or pool of assets.

The adviser must provide written disclosure of preferential treatment relating to any material economic terms (such as the cost of investing, liquidity rights, fee breaks, and co-investment rights) before the investor makes its investment in the fund. For current investors, in the case of an illiquid fund, the adviser must deliver a written notice, as soon as reasonably practicable following the end of the private fund’s fundraising period, disclosing all preferential treatment (including non-economic terms) the adviser or its related person has provided to other investors in the same private fund. For current investors, in the case of a liquid fund, the adviser must deliver written notice, as soon as reasonably practicable following the investor’s investment in the private fund, disclosing all preferential treatment (including non-economic terms) the adviser or its related person has provided to other investors in the same private fund.

The adviser is also required to distribute an annual written notice to current private fund investors where the notice provides specific information about any preferential treatment the adviser or its related person provides to other investors in the same private fund since the last written notice.

An adviser can comply with its written disclosure obligations by:

1. providing copies of any side letters with preferential terms to all investors in the fund (with identifying information of the other investors redacted) or
2. providing a written summary of the preferential terms, as long as the summary has sufficient and specific detail of such terms. SEC-registered advisers must maintain the required books and records to support their compliance with the preferential treatment rule, in accordance with amendments adopted to Rule 204-2.

Restricted Activities Rule. The Final Rule (Rule 211(h)(2)-1) restricts private fund advisers from engaging in certain activities unless specific disclosures are made and, in some cases, investor consent is obtained as further described below.

Restricted activities with disclosure-based exceptions include the following:

1. charging or allocating to the private fund any regulatory, compliance or examination fees or costs of the adviser or its related persons;
2. reducing any “adviser clawback” obligation (i.e., an obligation to restore or otherwise return any performance-based compensation pursuant to the governing documents of the fund) by the amount of any actual, potential or hypothetical taxes applicable to the adviser or its affiliates, or the respective owners thereof; and
3. charging or allocating fees and/or expenses related to a portfolio investment on a non-pro-rata basis when there are multiple vehicles or clients advised by the same adviser or its affiliates investing in the same portfolio investment (including any “broken deal” expenses for unconsummated transactions).

Restricted activities with certain investor consent exceptions are as follows:

1. charging or allocating to the private fund any fees or expenses associated with the investigation of the adviser or its related persons by any governmental or regulatory authority, except that charging or allocating fees or expenses arising from sanctions imposed for violating the Advisers Act or rules promulgated thereunder are flatly prohibited; and
2. borrowing, directly or indirectly, money, securities, or other fund assets (or otherwise receiving a loan or extension of credit) from a private fund client.

What is the effect of the Final Rules on all private fund advisers (regardless of whether they advise private funds or not)?

Written Annual Compliance Review Requirement. The Final Rules amend Rule 206(4)-7 under the Advisers Act to require all SEC-registered investment advisers, including those that do not advise private funds, to document in writing the required annual review of their compliance policies and procedures. This essentially codifies the current SEC position. There is no specified format for the documentation. All SEC-registered advisers are required to comply with amended Rule 206(4)-7 within 60 days after publication in the Federal Register.

When do the Final Rules become effective?

The Final Rules become effective 60 days after the date of publication in the Federal Register, but they have different transition periods and compliance dates.

- **For purpose of complying with the Annual Audit Rule (Rule 206(4)-10) and the Quarterly Statement Rule (Rule 211(h)(1)-2):** All SEC-registered private fund advisers are required to comply 18 months after publication of the rules in the Federal Register.
- **For compliance with all of the other Final Rules:** The compliance date varies. If the adviser has less than \$1.5 billion of assets under management attributable to private funds, the adviser has 18 months from the date of publication in the Federal Register in which to comply; if the adviser has assets under management attributable to private funds of \$1.5 billion or more, the adviser has 12 months from the date of publication in the Federal Register in which to comply.
- **For the Compliance Rule Amendments (Rule 206(4)-7):** The compliance date for all registered fund advisers (including those that do not advise private funds) is 60 days after publication in the Federal Register.

The Final Rules bring about sweeping changes to the private funds industry, requiring heightened disclosure, reporting and compliance obligations. Foster Garvey attorneys will continue to monitor developments concerning the Final Rules and will share further updates, as additional information becomes available, to help clients navigate the quickly shifting regulatory landscape. If you have questions about the Final Rules and how you may be impacted, please contact a member of our [Business & Corporate Finance team](#).