SEC Adopts Controversial and Sweeping Changes to Private Fund Rules; Requires Documentation of Annual Compliance Reviews

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On August 23, the Securities and Exchange Commission (SEC) voted 3-2 (with Commissioners Peirce and Uyeda dissenting) in favor of adopting new and amended rules under the Investment Advisers Act of 1940 (Advisers Act) that significantly impact the regulation of private fund advisers.

The private fund adviser reforms are designed specifically to address the following three factors for risks and harms that are common in an adviser's relationship with private funds and their investors: lack of transparency, conflicts of interest, and lack of effective governance mechanisms for client disclosure, consent, and oversight. [Adopting Release at 16.]

As proposed, different aspects of the final rules impact (i) SEC-registered private fund advisers; (ii) all private fund advisers (including exempt reporting advisers); and/or (iii) all SEC-registered investment advisers. In a change from the proposal, the final rule will not apply the majority of private fund adviser rules (discussed below) to advisers with regard to *securitized asset funds*. [Note, here and throughout, italicized terms are defined terms in the final rule].

As discussed below, the final rules are in many ways more permissive than the proposed rules (e.g., replacing flat prohibitions with disclosure-based exceptions), but will still meaningfully impact the contractual and business relationships between private funds and investors and may impact such funds' efforts to raise capital.

Rules Applicable to SEC-Registered Private Fund Advisers

- **Quarterly Statements (Rule 211(h)(1)-2).** Registered private fund advisers will be required to distribute to all private fund investors a quarterly statement that discloses information regarding (i) compensation, fees, and expenses paid to the adviser by the fund; (ii) similar fees and expenses paid by the fund; and (iii) *portfolio investment compensation* allocated or paid to the adviser (or any of its related persons) for each *covered portfolio investment*. The quarterly statement must include prominent disclosure regarding the manner in which compensation, fees, and expenses are calculated and include cross-references to the applicable sections of the private fund's organizational and offering documents. The adviser must also include specified fund-level historical performance information, the content of which varies depending upon whether the private fund meets the definition of a *liquid fund* or an *illiquid fund* (and present such information for the time periods prescribed in the rule). Generally, liquid funds will report various net total return figures, while illiquid funds will report gross and net IRR and MOIC metrics along with a statement of contributions and distributions. The quarterly statement must also include prominent disclosure of the criteria used and assumptions made in calculating the performance.

- While the proposed rule would have required that quarterly statements be distributed to fund investors within 45 days of the end of each quarter, the final rule modestly extends the reporting deadlines. Under the final rule, the quarterly statement must be delivered within 45 days of the end of each of the first three quarters of each fiscal year of the fund and within 90 days after the end of each fiscal year of the fund (and for private fund of funds, within 75 days and 120 days after the end of each of the first three quarters and end of the fiscal year, respectively).
- **Private Fund Audits (Rule 206(4)-10).** Registered private fund advisers will be required to cause each private fund they advise to undergo a financial statement audit that meets the requirements of the audit provision in Advisers Act Rule 206(4)-2 (the "Custody Rule"). Notably, the SEC proposed new Advisers Act Rule 223-1 (the "Safeguarding Rule") in February 2023, which if adopted, would replace the existing Custody Rule. Because of the link between the new private fund audit rule and the Custody Rule (and pending replacement of the Custody Rule with the Safeguarding Rule), the SEC has reopened the comment period for the Safeguarding Rule proposal (comments are due 60 days following publication in the *Federal Register*).
- **Adviser-Led Secondaries (Rule 211(h)(2)-2).** Registered private fund advisers, when conducting an *adviser-led secondary transaction* with respect to any private fund they advise, will be required to obtain and distribute to investors in the private fund a *fairness opinion* or *valuation opinion* from an *independent opinion provider*. The adviser will also be required to prepare and distribute to investors a summary of any material business relationships the adviser has, or has had within the prior two years, with the independent opinion provider.
- The final rule defines an adviser-led secondary transaction to mean "any transaction initiated by the investment adviser or any of its related persons that offers private fund investors the choice between [s] elling all or a portion of their interests in the private fund [ ] and converting or exchanging all or a portion of their interest in the private fund for interests in another vehicle advised by the adviser or any of its related persons."

Rules Applicable to All Private Fund Advisers (Including Exempt Reporting Advisers)

Restricted Activities. Under the final rule, all private fund advisers (including exempt reporting advisers) will be subject to additional obligations when engaging in certain restricted activities. In almost all cases, the SEC has softened these provisions by shifting from flat prohibitions at proposal, to restricted activities that are permitted with certain disclosures and/or investor consents.

- **Investigations (Rule 211(h)(2)-1(a)(1)).** The adviser may not charge a private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, unless the adviser requests and obtains written consent from, at least a majority in interest of the private fund's investors that are not related persons of the adviser. The adviser may not, however, charge the fund such fees where related to an investigation that results in a court or governmental authority imposing a sanction for violating the Advisers Act or rules thereunder.
- **Regulatory / Compliance Fees (Rule 211(h)(2)-1(a)(2)).** The adviser may not charge a private fund for any regulatory or compliance fees or expenses, or fees associated with an examination of the adviser or its related persons, unless the fees and expenses are disclosed in writing to investors within 45 days following the end of the fiscal quarter in which the charge occurs.
- **Adviser Clawbacks (Rule 211(h)(2)-1(a)(3)).** The adviser 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, unless the adviser distributes a written notice to investors that discloses the aggregate dollar amounts of the adviser clawback both before and after any reduction for such taxes, within 45 days following the end of the fiscal quarter in which the adviser clawback occurs.

- **Non-Pro Rata Fee Allocations (Rule 211(h)(2)-1(a)(4)).** The adviser may not charge or allocate fees or expenses related to a *portfolio investment* on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment, unless the allocation approach is fair and equitable and the adviser distributes to investors (prior to charging or allocating such fees) advance written notice of such charge and a description of how the allocation approach is fair and equitable under the circumstances.
- **Borrowings (Rule 211(h)(2)-1(a)(5)).** The adviser may not generally borrow or receive an extension of credit from a private fund client unless the adviser distributes to each investor a written description of the material terms of, and requests each investor to consent to, such borrowing or extension of credit, and obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser.

Preferential Treatment. Subject to enumerated exceptions, advisers will be prohibited from providing preferential terms to investors regarding (i) certain redemptions from the fund; and (ii) certain preferential information about portfolio holdings or exposures.

- **Redemption Preference (Rule 211(h)(2)-3(a)(1)).** The adviser may not grant an investor in the private fund (or in a 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 that private fund (or in a similar pool of assets), unless (i) the ability to redeem is required by applicable law or regulation to which the investor, the private fund, or any similar pool of assets is subject; or (ii) the adviser has offered the same redemption ability to all other existing investors and will continue to offer such redemption ability to future investors.
- **Portfolio Transparency Preference (Rule 211(h)(2)-3(a)(2)).** The adviser may not provide information regarding the portfolio holdings or exposures of a private fund (or in a *similar pool of assets*) to any investor in the fund if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund (or in a similar pool of assets), except if the adviser has offered the same information to all other existing investors at the same time or substantially the same time.

More generally, the rule will also prohibit advisers from providing any preferential treatment to investors, unless certain terms are disclosed to prospective investors (in advance of an investor's investment in the private fund) and all terms are disclosed to current investors (after the investor's investment).

- **Advance Notice to Prospective Investors (Rule 211(h)(2)-3(b)(1)).** The adviser must provide to each prospective investor in the private fund, prior to any investment in the fund, 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 private fund.
- **Notice to Current Investors (Rule 211(h)(2)-3(b)(2)).** The adviser must distribute to current investors written disclosure of all preferential treatment the adviser or its related persons have provided to other investors in the same private fund (for an illiquid fund, as soon as reasonably practicable following the end of the private fund's fundraising period; for a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund). In addition, at least annually, the adviser must provide written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided.

Legacy Status / Grandfathering Provision. In contrast with the proposed rule, the final rule provides legacy status for previously granted redemption and portfolio transparency preferences, as well as the restricted activities that require investor consent under the rule (i.e., investigation fees and borrowings). Legacy status applies to governing agreements that were entered into prior to the compliance date, if the final rule otherwise would require the parties to amend the agreements.

Rules Applicable to All SEC-Registered Advisers

- **Documentation of Annual Compliance Reviews (Rule 206(4)-7(b)).** All SEC-registered investment advisers will be required to review and document, in writing, and not less frequently than annually, the adequacy of the adviser's policies and procedures and the effectiveness of their implementation. The final rule does not prescribe the manner or format of such documentation (e.g., an adviser could aggregate documentation from reviews performed on a quarterly basis, incorporate a presentation to a board or LPAC, or include a short memorandum summarizing the findings of such review).

Other Notable Changes on Adoption

- **Fees for Unperformed Services.** The SEC did not adopt its proposed prohibition on charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment. The SEC, instead, noted its view that such activity is already inconsistent with an adviser's fiduciary duty.
- **Indemnification.** The SEC, similarly, did not adopt its proposed rule to prohibit an adviser to a private fund from, directly or indirectly, seeking reimbursement or indemnification from, or otherwise limiting its liability to, the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence (seemingly both simple and gross negligence), or recklessness, in providing services to the private fund. Rather than adopt this provision, the SEC noted that its concerns regarding these types of provisions can be addressed through the adviser's existing fiduciary duty. Citing to the 2019 Investment Adviser Fiduciary Interpretation, the SEC reiterated that "[w]hether contractual clauses that purport to limit an adviser's liability (also known as "hedge clauses" or "waiver clauses") in an agreement with an institutional client (e.g., private fund) would violate the Advisers Act's antifraud provisions will be determined based on the particular facts and circumstances."
- **Staggered Compliance Dates.** The final rules will be effective 60 days following publication in the *Federal Register*. In a change from the proposal (which provided for a one-year compliance period), the final rules provide staggered compliance dates as follows:
  - Quarterly statement rule and private fund audit rule: 18 months
  - Adviser-led secondaries rule, preferential treatment rule, and restricted activities rules:
    - Larger private fund advisers (at least $1.5 billion in private fund AUM): 12 months
    - Smaller private fund advisers (Less than $1.5 billion in private fund AUM): 18 months
  - Annual compliance rule: the effective date (i.e., 60 days following publication in the *Federal Register*).

Final Thoughts

In light of the flurry of recently adopted and pending proposed rules addressing the operations of investment advisers generally (including private fund advisers), as well as the recent and significant regulatory spotlight on private funds, it would be prudent for advisers to private funds to begin considering the aggregate impacts, burdens (both economically and operationally), and implementation challenges associated with these new rules.

Katten attorneys will be reviewing the final rules in more detail and plan to discuss key issues of importance to our clients in both an upcoming webinar and future publication.

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