Need to Know: SEC's New Private Fund Rules

The Securities and Exchange Commission ("SEC") recently adopted sweeping new rules (the "Rules") under the Investment Advisers Act of 1940 (the "Advisers Act") that include significant changes governing how private fund[1] advisers report, disclose, manage, and interact with investors.

On August 23, 2023, the SEC pushed further ahead in its effort to more closely and comprehensively regulate the $20 trillion private funds industry, dramatically shifting the regulatory landscape for advisers less accustomed to such broad obligations.[2] SEC Chair Gary Gensler, long a proponent of stronger private fund oversight, commented that the Rules "will promote private fund advisers' efficiency, competition, integrity, and transparency. That benefits investors, issuers, and the markets alike."[3] The Rules apply entirely to registered investment advisers with the SEC and in part to unregistered advisers.

The SEC's adoption of the Rules over two Commissioners' dissenting votes further confirms its intention to bring its regulation of private funds in line with investment vehicles more common in the retail investor space. But whether the Rules will ultimately come to fruition remains, for the moment, in flux.

On September 1, 2023, six trade organizations filed a lawsuit in the form of a Petition for Review pursuant to the Advisers Act in the Fifth Circuit challenging the validity and enforceability of the Rules,[4] alleging that the SEC exceeded its authority in adopting the Rules in violation of the Administrative Procedure Act and of the requirements for SEC rulemaking under the Advisers Act—an argument many in the private funds industry raised during the Rules' comment period.

The filing of the lawsuit does not automatically pause or otherwise affect the Rules, which will remain in effect unless and until the Fifth Circuit vacates them. The parties must still fully brief the issues for the court.

Compliance Timeline

The Rules will take effect on November 13, 2023, and all advisers (regardless of registration) will be required to comply with the amended Compliance Rule (discussed below) as of that date.

- The compliance date for the Quarterly Statement and Audit Rules will take effect 18 months after publication in the Federal Register: March 14, 2025.
- The compliance dates for the Adviser-Led Secondaries, Preferential Treatment, and Restricted Activities Rules vary:

Advisers with $1.5 billion or more in AUM	Advisers with less than $1.5 billion in AUM
Have 12 months to comply: September 14, 2024	Have 18 months to comply: March 14, 2025

Next Steps for Private Fund Advisers

The Rules fall into five broad categories: Quarterly Statement Rule, Audit Rule, Adviser-Led Secondaries Rule, Restricted Activities Rule, and Preferential Treatment Rule. **The Quarterly Statement, Audit, and Adviser-Led Secondaries Rules will apply only to SEC-registered advisers, while the Restricted Activities and Preferential Treatment Rules will apply to all advisers, regardless of registration status.**

The Rules present private fund advisers with material changes that will require advisers to adapt across many aspects of their business. While some advisers may have already incorporated certain of the Rules' changes into their policies and investor outreach approaches, the scope of the new requirements should compel private fund advisers to evaluate how to integrate the amendments most efficiently and cost-effectively into their compliance programs. Advisers should expect investors to inquire about the new disclosure requirements and should work with compliance personnel to adopt a consensus position on the firm's implementation of the Rules, particularly with respect to requests concerning preferential treatment. We expect additional SEC and industry guidance and commentary over the coming months and will provide updates as appropriate.

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For more information about Government Investigations and Private Funds, including updates on forthcoming SEC and industry guidance and commentary, visit our website: www.goulstonstorrs.com/government-investigations and www.goulstonstorrs.com/private-investment-funds

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The New Rules[5]

1. **Quarterly Statement Rule**[6]: The Rules require that registered investment advisers distribute quarterly statements to fund investors disclosing substantial and detailed information about the fund's investments and performance. As the Adopting Release points out, "[t]he quarterly statement rule is designed to facilitate the provision of simple and clear disclosures to investors regarding some of the most important and fundamental terms of their relationships with investment advisers to private funds in which those investors invest—namely what fees and expenses those investors will pay and what performance they receive on their private fund investments."[7]

   The quarterly statement must include a table showing fund-level information and a separate table showing information at the portfolio investment level. The statement must also provide specified performance information.

   When it comes to the Quarterly Statement Rule, registered private fund advisers should also keep in mind:
   - There are no exemptions for small or emerging advisers, and the requirement cannot be waived.[8]
   - The fund table must reflect the below information, both before and after the application of any offsets, rebates, or waivers:

Fund Table Required Information
❖ A detailed accounting of all compensation, fees, and other amounts paid to the adviser or its related persons during the accounting period, with a separate line item showing each category of payment, including performance-based compensation,[9] as well as management, advisory, sub-advisory and similar fees, along with the total dollar amount for each category; ❖ A detailed accounting of all other fees or expenses allocated to or paid by the fund, with separate categories that include organizational, accounting, legal, administration, audit, tax, due diligence and travel; and ❖ The amount of any offsets or rebates carried forward during the reporting period to future periods that will reduce payments or allocations to the adviser or its related persons.

   - The portfolio investment table must include a detailed accounting of all portfolio investment compensation allocated or paid to the adviser or a related person by each portfolio investment, with a separate line item for each category of compensation and the total amount paid.
   - The performance information included in the statement differs between liquid and illiquid funds.[10]
     - The adviser must provide—for liquid and illiquid funds—the applicable calculation methodology and cross references to relevant sections of the organizational and offering documents.
     - The interests of the adviser and its affiliates in the fund generally should be excluded from the performance calculations.

2. **Audit Rule**: Registered private fund advisers will be required to obtain a financial statement audit that satisfies the audit provision under the Custody Rule,[11] and to deliver the audited financial statements to investors as required under Custody Rule. A surprise examination under the Custody Rule will not satisfy the requirements of the Audit Rule, effectively eliminating the surprise examination option.

Liquid funds must include: (i) annual net total returns for each of the past ten years or, if shorter, from inception; (ii) average annual net total returns over the most recent one-, five- and ten-fiscal-year periods; and (iii) cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter.

Illiquid funds must include the following performance measures, shown since inception and computed with and without any fund-level subscription facilities: (i) gross internal rate of return and gross multiple of invested capital; (ii) Net internal rate of return and net multiple of invested capital; and (iii) 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. Advisers to illiquid funds must also provide a statement of contributions and distributions from the fund.

3. **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 in connection with adviser-led secondary transactions. These fund advisers must further provide investors with a summary of any "material business relationships" the adviser has, or has had within the prior two years, with the independent opinion provider. As the Adopting Release explained: "By requiring that investors receive a third-party opinion and a written summary of any material business relationships before deciding whether to participate in an adviser-led secondary transaction, the final rule will help prevent investors from being defrauded, manipulated, and deceived when the adviser is on both sides of the transaction."[12]

   The Rule defines an "Adviser-Led Secondary" transaction as any transaction initiated by a registered adviser or a related person that offers investors a choice between: (i) selling all or a portion of their interests in the private fund and (ii) 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.[13]

4. **Restricted Activity Rule (applies to advisers)**: The Restricted Activity Rule covers five categories of activities, three of which have disclosure-based exceptions and two of which have exceptions that require disclosure and investor consent:

Restricted Activities with Disclosure-Based Exceptions	Restricted Activities with Consent-Based Exceptions[15]
An adviser may not: ❖ Charge or allocate any regulatory, compliance, or examination-related fees or expenses of the adviser or a related person unless the adviser distributes to investors a written notice describing the fees and expenses, including the dollar amount, within 45 days of the end of the fiscal quarter in which the charges occur;	**An adviser may not:** ❖ Charge or allocate fees or expenses associated with regulatory investigations of the adviser or its related persons unless the adviser seeks advance consent from all investors and obtains written consent from at least a majority of investors that are not related persons of the adviser; or
❖ Reduce the amount of an adviser clawback by any actual or hypothetical taxes payable by the adviser or its related persons unless the adviser distributes to investors written notice of the total amount of the pre-tax and post-tax clawback within 45 days of the end of the fiscal quarter in which the clawback occurs; or	❖ Borrow money, securities, or other assets, or receive a loan or extension of credit, from a private fund unless the adviser first: • Distributes to each investor a written description of the material terms of the proposed transaction with a request for consent; and • Obtains written consent from at least a majority of investors that are not related persons of the adviser.
❖ Allocate fees or expenses on a non-pro rata basis related to an investment where multiple private funds and/or clients advised by the adviser have invested in the same portfolio investment unless: • The allocation is "fair and equitable under the circumstances";[14] and • Before making the allocation, the adviser distributes written notice to investors of the allocation and an explanation of why it is fair and equitable.	

Although private fund advisers do not typically "borrow" from a fund they advise, in certain instances the mechanics of the fund's accounting may constitute borrowing under the Rules; for example, where an adviser uses future performance compensation to satisfy its fund commitment.

Importantly, although not surprisingly, the Rule prohibits an adviser under all circumstances from charging or allocating any fees or expenses in connection with an investigation that results in the adviser being sanctioned for violating the Advisers Act or the rules thereunder. If an investigation for which an adviser has already allocated fees or expenses to a fund results in a sanction, the adviser must reimburse the fund.[16]

5. **Preferential Treatment Rule (applies to all advisers)**[17]: Under Chair Gensler, the SEC has clearly expressed its concerns with an adviser's preferential treatment of investors. The Rules codify that focus and put at issue core private fund practices that will require the industry to reevaluate how it manages preferential redemption, information, and other related rights:

   - Preferential Redemption Rights: An adviser may not grant preferential redemption rights to an investor that the adviser "reasonably expects to have a material, negative effect on other investors in that private fund," unless: (i) the redemption right is required by applicable law or regulation; or (ii) the adviser has offered the same redemption rights to all other investors and will continue to offer them to future investors without qualification.[18]

   - Preferential Information Rights: An adviser may not provide information about the holdings or exposures of a private fund to any fund investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in the fund unless the adviser offers the information to all investors in the fund at the same time or substantially the same time. This Rule applies regardless of the manner of communication: formal and informal as well as written, visual, and oral.

   - Preferential Treatment, Generally: An adviser may not provide any preferential treatment – including preferential redemption, information, and other key terms and benefits (such as limited indemnification obligations or specific investment participation rights) – to any private fund investor unless the adviser:
     - ✓ provides to each prospective investor, before the investor's investment in the fund, written notice that provides specific information of any preferential treatment related to any material economic terms provided to other investors in the same fund;[19]
     - ✓ distributes to each current investor written disclosure of all preferential treatment provided to the investors as soon as reasonably practicable after the end of an illiquid fund's fundraising period or after an investor's investment in a liquid fund; and
     - ✓ provides, at least annually, written notice to investors with specific information any new preferential treatment provided since the adviser's last notice.

"Legacy Status" for Already Active Funds

The Rules governing investigation-related expenses and borrowing, as well as the restrictions on preferential redemption and information rights, will not apply to "contractual agreements"—including limited partnership agreements, subscription agreements, or side letters—governing a fund that has commenced operations[20] as of the Rules' compliance date and that were entered into in writing before the compliance date, if the Rules would otherwise have required amending those agreements ("Legacy Status"). In other words, if the governing documents and agreements for existing funds permitted certain of the now restricted activities and preferential treatment requirements, advisers need not revise or amend those documents. The Legacy Status provisions apply only to existing agreements with parties as of the compliance date.

Notably, Legacy Status will not apply to the disclosure portions of the preferential treatment rule because the SEC determined that the transparency resulting from disclosure would not cause harm to investors. The Release thus cautions that, "[a]s a result, information in side letters that existed before the compliance date will be disclosed to other investors that invest in the fund post compliance date."[21]

Compliance Rule Change

The Rules require all SEC-registered advisers to document in writing the required annual review of their compliance policies and procedures. The SEC did not specify the format or content of the adviser's policies and procedures, currently leaving the adviser—for better or worse—with a certain degree of discretion.[22]

For more information about Government Investigations and Private Funds, including updates on forthcoming SEC and industry guidance and commentary, please contact **Jackie Grodin** or **David Coombs**, or visit our website: www.goulstonstorrs.com/government-investigations and www.goulstonstorrs.com/private-investment-funds.

Endnotes

[1] A "private fund" is an issuer of securities (*e.g.*, limited partnership interests) that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act. See Form ADV, Glossary of Terms, at 34, available here.

[2] The Rules will not apply to any securitized asset funds (SAFs), which are defined in the Rules as "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders."

[3] Chair Gary Gensler Statement on Private Fund Advisers, August 23, 2023, available here.

[4] The petitioners in the suit are: (i) National Association of Private Fund Managers; (ii) Alternative Investment Management Association: (iii) American Investment Council: (iv) Loan Syndications and Trading Association; (v) Managed Funds Association; and (vi) National Venture Capital Association.

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

[6] For a private fund that is not a fund-of-funds, the statement must be delivered within 45 days of the end of each of its first three fiscal quarters of the fund's fiscal year and within 90 days of the end of its fiscal year. The statement for a fund-of-funds must be delivered within 75 days of the end of its first three fiscal quarters and within 120 days of the end of its fiscal year.

[7] Adopting Release at 59-60.

[8] Adopting Release, at 68-69: "It is important for all investors in private funds advised by SEC-registered advisers to receive sufficiently detailed, comprehensible, and regular information to enable investors to monitor whether fees and expenses are being mischarged and to ensure that accurate performance information is being clearly presented. . . .Accordingly, we are not providing any exemptions to the quarterly statement rule for small or emerging advisers."

[9] The Rule defines "performance-based compensation" to include "allocations, payments, or distributions of capital based on [a] private fund's (or its investments') capital gains, capital appreciation and/or other profit." There are no de minimis exceptions. Advisers may not group expenses into broad categories or label expenses as "miscellaneous." The final Rule clarifies that the table must cover both expenses "paid by" and those "allocated to" the private fund. See Adopting Release at 82-83.

[10] Adopting Release at 121-23.

[11] Investor Advisers Act Rule 206(4)-2

[12] Adopting Release at 24.

[13] Adopting Release at 189.

[14] Whether an allocation is fair and equitable will depend on the facts and circumstances for a specific expense. As the SEC explains: "For example, it would be relevant whether the expense relates to a specific type of security that one private fund client holds. In another example, a factor could be whether the expense relates to a bespoke structuring arrangement for one private fund client to participate in the portfolio investment. As yet another example, another factor could be that one private fund client may receive a greater benefit from the expense relative to other private fund clients, such as the potential benefit of certain insurance policies." Adopting Release at 228.

[15] Importantly, blanket consents in a private fund's governing documents will not comply with the Rule's consent requirements for investigation-related fees and expenses, and such consent must be obtained for each discrete activity. *See* Adopting Release at 236: "Such fees and expenses are related to the adviser's potential or actual wrongdoing and should be borne by the adviser unless investors consent in writing to paying them for each specific investigation."

[16] This prohibition is not covered by the legacy status provision and applies to all funds, past and future.

[17] Note that "advisers are not required to disclose the names or even types of investors provided preferential terms as part of this disclosure requirement." Adopting Release at 293.

[18] *See* Adopting Release at 274-280.

[19] The notice should not be vague or general and should instead provide concrete information regarding the nature of the preferential treatment: what are the lower fee rates charged to the preferred investor, for example, and the terms by which the investor secured the preferred rates.

[20] Examples of activity that could indicate a private fund has commenced operations include issuing capital calls, setting up a subscription facility for the fund, holding an initial fund closing and conducting due diligence on potential fund investments, or making an investment on behalf of the fund. Adopting Release at 312-313.

[21] *See* Adopting Release at 313.

[22] According to the Adopting Release (at 310-11), the SEC "did not prescribe a specific format for the written documentation, allowing advisers flexibility to record the results of the annual review in a manner that best fits their business and to use the review procedures that they have found most effective. Thus, whenever the adviser commences its review within the next 12 months after the compliance date, the review must be documented in writing."