New SEC Rules Enhance Regulation of Private Fund Advisers

Ryan Nichols

Partner
303.295.8298
Boulder, Denver
rlnichols@hollandhart.com

Amy Bowler

Partner
303.290.1086
Denver
abowler@hollandhart.com

Cris Wilcoxon

Associate
702.222.2532
Las Vegas
cgwilcoxon@hollandhart.com

Insight — September 14, 2023

Recently, the Securities and Exchange Commission (the "**SEC**") adopted much anticipated rules under the Investment Advisers Act of 1940 (the "**Advisers Act**") aimed at (i) bolstering the regulation of private fund advisers and practices that the SEC believes may cause harm to investors in private funds and (ii) increasing transparency. The rules reflect the SEC's insights gained from over a decade of oversight of private fund advisers post-Dodd-Frank and target the SEC's three primary areas of concern identified during this time: lack of transparency, conflicts of interest, and lack of sufficient governance mechanisms.

These new rules require **registered private fund advisers** to:

- Provide quarterly statements to investors in private funds detailing information on the private fund's fees, expenses, and performance.

- Cause each private fund to obtain an annual audit and deliver the audit and other materials to its investors.

- Obtain a fairness opinion or valuation opinion for any adviser-led secondary transaction and distribute to the private fund's investors a description of any material business relationships within the last two years between the independent opinion provider and the adviser or its related persons.

The new rules prohibit **all private fund advisers** from:

- Engaging in certain restricted activities, including: charging expenses associated with the investigation of the adviser, except in certain cases with investor consent; charging regulatory, compliance, or examination expenses to investors, or reducing any adviser clawback for taxes, without prior disclosure to investors; allocating expenses to a private fund on a non-pro rata basis, unless the alternative allocation is fair and equitable, and disclosed to the investors; or borrowing from a private fund client without investor consent.

- Providing certain types of preferential treatment to investors, while allowing other types of preferential treatment only if appropriately disclosed to investors.

The amendments also (i) require **all registered advisers** to document the annual review of their compliance policies and procedures, and (ii) impose additional recordkeeping requirements related to the new rules.

Requirements

For Registered Private Fund Advisers

Registered private fund advisers must comply with the following rules:

- **Quarterly Statement Rule.** Registered private fund advisers must distribute a quarterly statement to private fund investors that discloses fund-level information on performance, the cost of investing in the private fund, fees and expenses paid by the private fund, and compensation and other amounts paid to the adviser.
  - *Non-funds of funds* must distribute quarterly statements within 45 days after each of the first three fiscal quarters and within 90 days following the fiscal year end.
  - *Funds of funds* must distribute quarterly statements within 75 days after each of the first three fiscal quarters and 120 days following the fiscal year end.

  Fee and Expense Disclosure*.* The quarterly statement rule requires tabular disclosure of certain information related to private fund fees, expenses and compensation paid or allocated to the adviser or its related persons during the prior quarterly period. A quarterly statement must include:

  - Adviser Compensation – Detailed accounting of all fees, compensation, or other amounts allocated or paid by the private fund (or allocated or paid by a covered portfolio investment) to the adviser or any of its related persons during the reporting period, with a separate line item for each category. No *de minimis* exemption is available and the adviser may not group expenses into broader categories or label expenses as miscellaneous.
  - Fund Fees and Expenses – Detailed accounting of all fees and expenses borne by the private fund during the reported quarter (other than those disclosed as adviser compensation), with each category of expenses listed as a separate line item and not as broad groups of categories.
  - Offsets, Rebates, and Waivers – Adviser compensation and fund expenses must be presented before and after the application of any offsets, rebates or waivers. Quarterly statements must present the amount of any offsets or rebates from the current quarter that are rolled over to subsequent quarters to reduce future payments or allocations to the adviser or its related persons in such subsequent quarters.

- Calculations – Disclosure regarding the manner by which expenses, payments, allocations, rebates, waivers, and offsets are calculated, with cross-references to the relevant sections of the private fund's organizational documents that set forth the applicable calculation methodology.

Performance Information. In addition to information regarding fees and expenses, quarterly statements must include standardized performance information, the content of which is determined based on whether a private fund client is a liquid fund or an illiquid fund, and which must be accompanied by prominent disclosure of the criteria used and assumptions made in calculating the private fund's performance.

- *Illiquid Fund Performance Reporting*
    - An illiquid fund generally means a private fund that is not required to redeem interests on request and provides limited opportunities for investors to withdraw during the term of the private fund.
    - Advisers must report an illiquid fund's gross and net internal rates of return (i.e., the discount rate that causes the net present values of cash flows through the life of the private fund to equal zero) ("IRR"), gross and net multiple of invested capital (i.e., the private fund's aggregate value relative to invested capital) ("MOIC"), and gross IRR and gross MOIC for realized and unrealized portions of the illiquid fund's portfolio (with realized and unrealized performance show separately), in each case since the illiquid fund's inception.
    - Advisers must present a statement of contributions (i.e., capital inflows received by the private fund) and distributions (i.e., capital outflows distributed to the private fund's investors) since inception and the net asset value of the private fund as of the end of the period covered by the quarterly statement.
    - Advisers must calculate performance results for each illiquid fund with and without the impact of fund-level subscription facilities (i.e., credit facilities secured by the unfunded commitments of the private fund investors).
    - In recognition that certain private funds may need information from portfolio investments and other parties to generate performance data, if the most recent quarter numbers are not available, advisers must include performance measures through the

most recent practicable date.

- *Liquid Fund Performance Reporting*
    - A liquid fund means a private fund that is not an illiquid fund.
    - Advisers must report a liquid fund's: (i) annual total net return for last ten fiscal years or since its inception (whichever period is shorter); (ii) average annual net total returns over one-, five-, and ten-fiscal year periods; and (iii) the cumulative net total returns for the current fiscal year up to the latest quarter covered by the quarterly statement.

- **Private Fund Audit Rule**. Registered investment advisers providing advice to private funds, directly or indirectly, must cause the private funds to undergo annual financial statement audits that meet the requirements of the existing custody rule's audit provision. The audited financial statements must be delivered to the private fund's investors within 120 days after the end of each fiscal year and promptly on liquidation. Any adviser that does not have sufficient control over a private fund client to cause such private fund client's financial statements to undergo an audit, must take all reasonable steps to cause the private fund to undergo an audit that satisfies the rule. The audit must be performed by an independent public accountant that meets the standards of independence set forth in Regulation S-X and that is registered with and subject to regular inspection by the PCAOB. The audited financials must be prepared in accordance with U.S. generally accepted accounting principles and the audit must be conducted in accordance with U.S. generally accepted auditing standards.

- **Adviser-Led Secondaries Rule**. Registered private fund advisers must (i) obtain a fairness opinion or a valuation opinion when offering to existing private fund investors the option to either sell their interests in a private fund or convert or exchange their interests in the private fund for interests in another vehicle (i.e., a continuation vehicle) advised by the adviser or its affiliates and (ii) deliver such opinion to investors prior to the due date of the election form for the transaction. The rule also requires the adviser to prepare and distribute to the private fund's investors a summary of any material business relationships the adviser or its related persons had with the independent opinion provider within the past two years.

For All Private Fund Advisers

All private fund advisers must comply with the following rules:

- **Restricted Activities Rule**. This new rule restricts all private fund advisers from engaging in the following conduct:
    - **Compliance, Regulatory, and Examination Costs**.

Charging or allocating to a private fund any adviser regulatory, examination, or compliance fees, unless such fees are disclosed to investors at least quarterly.

- **Clawback Transparency**. Reducing the amount of an adviser clawback by the amount of taxes (actual, potential, or hypothetical), unless the adviser discloses to investors the aggregate dollar amount of the adviser clawback before and after the application of the tax reduction.

- **Non-Pro Rata/Equitable Fee and Expense Allocations**. Charging or allocating fees or expenses related to a portfolio investment in which multiple private funds and other clients advised by the adviser or its related persons have invested, other than on a pro rata basis, unless the allocation approach is fair and equitable under the circumstances and the adviser distributes advance written notice of the non-pro rata charge or allocation with an accompanying description of how the allocation approach is fair and equitable under the circumstances.

- **Investigation Fees**. Charging or allocating to a private fund any fees or expenses associated with an investigation of the adviser by any governmental or related authority, unless such fees are disclosed to the private fund's investors and at least a majority in interest of the private fund's investors that are not related persons of the adviser consent to charging the private fund for such investigation fees or expenses. Regardless of the disclosure to or consent received from the private fund's investors, the adviser may not charge 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.

- **Borrowing Limits**. Borrowing funds from a private fund client unless the adviser distributes a written notice and description of the material terms of the borrowing to the private fund's investors and at least a majority in interest of the private fund's investors that are not related persons of the adviser consent to such borrowing.

- **Preferential Treatment Rule**. Private fund advisers may not provide to private fund investors:
  - Preferential rights to redeem an investor's interest in the private fund if the adviser reasonably expects such preferential rights to have a material, negative effect on other investors in that private fund or a similar pool of assets, unless the investor is required by applicable law, rule, regulation, or order to redeem its interests or the

adviser has offered such liquidity rights to all other investors.

- Information regarding portfolio holdings or exposures to the private fund or substantially similar pool of assets to any investor if the adviser reasonably expects that providing such information would have a material, negative effect on other investors in that private fund or a similar pool of assets, unless the same preferential information is offered to all other investors at the same time or substantially the same time.

The Preferential Treatment Rule also prohibits private fund advisers from providing preferential treatment to investors unless certain terms are disclosed in advance of an investor's investment in the private fund and all terms are disclosed after the investor's investment and annually thereafter.

Legacy Status. The SEC will provide legacy status for the Preferential Treatment Rule prohibitions and the investor consent requirements of the Restricted Activities Rule, although advisers will be prohibited from charging fees or expenses relating to an investigation that results in sanctions for violations of the Advisers Act. This legacy status applies to governing agreements that were entered into prior to the compliance date if the applicable rule would require the parties to amend the agreements.

Note: The new rules do not apply to private fund advisers with respect to their securitized asset funds.

For All Registered Advisers

All registered advisers must comply with the following:

- **Compliance Rule Amendments**. The amendments require all registered advisers (including those that do not advise private funds) to document the annual review of their compliance policies and procedures in writing.

- **Books and Records Rule Amendments**. The amendments to the Advisers Act “books and records” rule require investment advisers to private funds to make and keep records relating to the actions and disclosures required by the new rules (including records substantiating the calculations and determinations required under the new rules).

Compliance Deadlines

Compliance with the amended Advisers Act rules will be required 60 days after publication in the Federal Register. The Quarterly Statement Rule and the Audit Rule will apply 18 months after publication in the Federal Register. The Adviser-Led Secondaries Rule, Preferential Treatment Rule, and Restricted Activities Rule will apply, with respect to advisers with $1.5 billion or more in private fund assets, 12 months after publication and, with respect to advisers with less than $1.5 billion in private fund assets under management, 18 months after publication.