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The SEC's Private Fund Adviser Rules

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Overview of New Rules

The SEC did not adopt a proposed rule prohibiting indemnification

Final Rule's adopting discusses the SEC's views regarding indemnification practices.

New rules that apply to all Investment Advisers that manage private funds*

Rule 211(h)(2)-3(a)	An effective prohibition on preferential liquidity and portfolio transparency rights **if** materially harmful to other LPs
Rule 211(h)(2)-3(b)	Required disclosure of other preferential terms
Rule 211(h)(2)-1	Restrictions on other activities, including non-pro rata fee and expense allocations, charging the advisers' regulatory and investigations expenses to the funds, and reducing adviser clawbacks for taxes

New rules that apply only to SEC-registered investment advisers (RIAs)*

Rule 211(h)(1)-2	New requirements for standardized annual and quarterly fund reporting of performance and fees and charges
Rule 211(h)(2)-2	Mandatory valuation/fairness opinion for GP-led secondary transactions
Rule 206(4)-10	All private funds must be audited
Rule 206(4)-7	All RIAs required to document annual compliance reviews

* Rules do not apply to offshore advisers with respect to their management of non-U.S. private funds.

Compliance Dates

All compliance dates are calculated based on the September 14, 2023 publication of the rules in the Federal Register.

- **November 14, 2023:** Compliance Rule Amendments for all RIAs
- **September 14, 2024:** All other rules except the quarterly and annual reporting requirements
- **March 14, 2025:** Quarterly and annual reporting

Scope / Applicability

Private Funds

- The Rules apply to funds that excluded from the definition of "investment company" based on Section 3(c)(1) or 3(c)(7) of Investment Company Act, **except** that the Rules do not apply to investment advisers with respect to "securitized asset funds" that they advise.
  - Securitized asset fund is defined as "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders," and includes collateralized loan obligations (CLOs).
- However, the preferential treatment Rules prohibit an adviser from granting certain preferential treatment to a "similar pool of assets."

Preferential Treatment /Prohibited Activity

The Rules prohibit investment advisers from providing preferential ***liquidity*** (*i.e.*, redemption rights) or ***informational rights*** that the adviser reasonably expects to have a material negative effect on fund investors, unless this treatment is offered to other investors in the private fund and any similar pool of assets.

- An adviser can allow an investor to redeem if such redemption right is required by law applicable to the investor, fund or similar pool of assets.

The Rules prohibit other preferential ***material economic terms*** are disclosed in advance of an investor's investment in the private fund and all preferential terms are disclosed after the investor's investment.

- **Disclosure to prospective investors.** The Rule requires advance written notice to prospective investors of any material p[referential economic terms.

- **Disclosure to all investors.** The adviser must also send written notice of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund (i) for an illiquid fund, as soon as reasonably practicable following the end of the fund's fundraising period and (ii) for a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund.

- **Annual disclosure.** Advisers also still required to provide to current investors comprehensive, annual disclosure of all preferential treatment (including non-economic terms) provided by the adviser or its related persons since the last annual notice.

Other Restricted Activities

- ***Certain Non-Pro Rata Fee and Expense Allocations***. An adviser is prohibited from charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by it or its related persons have invested (or propose to invest) in the same portfolio investment **unless** (i) the allocation approach is fair and equitable, **and** (ii) the adviser distributes to fund investors advance written notice of the non-pro rata charge and a description of how the allocation approach is fair and equitable under the circumstances.
- ***Borrowing From Private Fund Clients.*** Advisers may not borrow or receive an extension of credit from a private fund client without disclosure to, and consent from, fund investors. Advisers must distribute a written notice and a description of the material terms of the borrowing (*e.g.*, the amount of money to be borrowed, the interest rate, and the repayment schedule) and obtain written consent from at least a majority in interest of the fund's investors that are not related persons of the advisers.
- ***Regulatory, Compliance and Examination Expenses***. Advisers are prohibited from charging or allocating to the private fund regulatory, examination, or compliance fees or expenses of the adviser, unless such fees and expenses (including the dollar amounts thereof) are disclosed to investors. Disclosure is required within 45 days after the fiscal quarter in which the fees or expenses were incurred.
- ***Investigation Expenses***. Advisers must obtain consent from fund investors if the adviser charges or allocates to the private fund any fees or expenses associated with an investigation of the adviser. An adviser may not charge fees or expenses that results in a court or governmental authority imposing a sanction for a violation of the Advisers Act or the rules thereunder.
- ***Reducing Adviser Clawbacks for Taxes***. Advisers are restricted from reducing the amount of an adviser (or affiliate) clawback by the amount of certain taxes unless the post-tax clawback is subject to after-the-fact disclosure. Specifically, an adviser must disclose, in a written notice to the investors of the impacted private fund, the aggregate dollar amounts of the adviser clawback both before and after the reduction of the clawback for actual, potential, or hypothetical taxes. The notice must be provided within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.

Reporting – Quarterly Reporting

RIAs must provide private fund investors with quarterly statements about the fund's performance as well as fees and expenses.

- With respect to fund performance, the Private Fund Adviser Rules require advisers to provide performance metrics that are standardized and cover specified periods, both of which vary depending on whether the adviser determines that the private fund is a "liquid" or "illiquid" fund, as defined in the Rules
  - For illiquid funds, the Rule requires that performance is calculated both with and without the impact of fund-level subscription facilities (*i.e.*, levered and unlevered returns) and without the inclusion of the adviser or its affiliates investment in the fund
  - For newly formed funds, advisers are required to provide these performance metrics after the first two full quarters of operating results for the fund
- The fee and expense information must include ***any compensation paid or allocated to the adviser or its related persons*** by the fund and by the fund's underlying portfolio investments.

Timing of delivery:

- If the private fund is not a fund of funds, distribute ***within 45 days*** after the end of each of the first three fiscal quarters of each fiscal year and ***90 days*** after the end of each fiscal year
- For a private fund that is a fund of funds, distribute within ***75 days*** after the first, second, and third fiscal quarter ends, and ***120 days*** after the end of the fiscal year of the fund of funds

RIA must retain (i) a copy of quarterly statements and each addressee to whom they were provided, (ii) records evidencing all calculation methodologies, and (iii) records evidencing its determination of whether each fund is liquid or illiquid

Reporting – Fund Audits

RIAs are required to obtain an annual financial statement audit of each private fund that they directly or indirectly advise

- An audit will comply with the final Rules requirement if it is conducted in accordance with the audit provision (and related requirements for delivery of audited financial statements) under the current Custody Rule (Rule 206(4)-2 under the Advisers Act), and it appears that SEC staff guidance and FAQs related to the Custody Rule audit provision would also be applicable to the audit required by the Private Fund Adviser Rules

Document retention obligation: Rule 204-2(a) of the Advisers Act is amended to require RIAs to maintain a copy of each private fund's audited financial statements

Reporting – Fairness or Valuation Opinion for Adviser- or GP-Led Secondary Transactions

RIAs must obtain a fairness opinion or a valuation opinion from an independent third party in connection with adviser-led secondary transactions.

Definition of "adviser-led secondary transaction": "Transactions initiated by the investment adviser or its related persons that offer investors the choice between selling all or a portion of their interests in the private fund and converting and exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or its related persons."

- Includes transactions involving continuation funds
- Does not include tender offers
- Other types of transactions depend on the facts and circumstances

Reporting – Fairness or Valuation Opinion for Adviser- or GP-Led Secondary Transactions – Cont'd.

RIAs must also prepare a written summary of any material business relationships between the adviser and its related persons and the independent opinion provider within the two-year period immediately prior to the date that the fairness opinion or valuation opinion is issued

The fairness or valuation opinion and the summary any material business relationships must be distributed to private fund investors prior to the due date for investors to submit the election form. RIAs must retain a copy of fairness opinion or valuation opinion and the material business relationship summary, as well as a record of each addressee to whom these materials were distributed and the date of distribution

Document retention obligation: Rule 204-2(a) of the Advisers Act requires RIAs to retain, for each adviser-led secondary transaction, a copy of fairness opinion or valuation opinion and the material business relationship summary, as well as a record of each addressee to whom these materials were distributed and the date of distribution

Legacy Status and Grandfathering

The Final Rules provide for "Legacy" status or "grandfathering" with respect to the Preferential Treatment Rules and certain Restricted Activities that would require investor consent/revision of governing documents.

To be eligible for Legacy status, the governing documents for the private fund must have been entered into before the compliance date for the applicable Rule provision and the funds must have commenced operations, including:

- investment, fundraising, or operational activity such as issuing capital calls
- setting up a subscription activity for the fund
- holding an initial fund closing, conducting due diligence on potential fund investments
- making an investment on behalf of the fund

Legacy Status is <u>not</u> available for any of the other Rules provisions.

Disclosure requirements of the Preferential Treatment Rules do apply to pre-existing funds that qualify for Legacy status

Amendment to Compliance Rule

The SEC also amended Rule 206(4)-7 under the Advisers Act (the "Compliance Rule") to require all RIAs to document in writing their annual review of their compliance policies and procedures.

- This amendment to the Compliance Rule does not mandate a particular form or format for the RIA's documentation of its compliance policies and procedures.

- The compliance date for this amendment is substantially earlier than the compliance date for other provisions: ***November 14, 2023***

Q & A

Thank you.