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Locke Lord QuickStudy: SEC Makes Regulatory “Sea Change” ?Official With Adoption of New Rules for Private ?Fund Advisers

FUNDamentals™ Series

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On August 23, 2023, the U.S. Securities and Exchange Commission (SEC) adopted (via 3-2 vote of the Commissioners) a package of five key new rules and amendments (Final Rules) to existing rules under the Investment Advisers Act of 1940 (Advisers Act). The Final Rules are based on the package of rules and amendments that was proposed by the SEC in early 2022 (Proposed Rules) and the relevant comments received during an extended comment period.

In summary, the SEC intends that the Final Rules will enhance adviser transparency and investor protections by:

- mandating disclosure or investor consent with respect to certain restricted activities, including conflicts of interest and compensation schemes (Restricted Activities Rule);
- prohibiting or restricting private fund advisers from providing investors with preferential treatment regarding redemptions and information rights, if such treatment would have a material, negative effect on other investors, or material economic terms, subject to certain exceptions and disclosure requirements (Preferential Treatment Rule);
- adding third-party fairness opinion or valuation requirements for adviser-led secondary transactions (Adviser-Led Secondaries Rule);
- mandating the audit of private fund financial statements to, among other things, serve as a check against misappropriation of assets and calculation of adviser fees (Audit Rule); and
- requiring standardized quarterly statements detailing certain information regarding fund fees, expenses, and performance (Quarterly Statement Rule).

As noted in our prior article in Bloomberg Law, the adoption of the Final Rules expands the SEC’s regulatory oversight of investment advisers, including exempt reporting advisers, and in certain cases preempts arrangements negotiated between private fund advisers and investors. Following the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the SEC’s regulatory oversight regarding private funds was primarily limited to requiring certain investment advisers to register under the Advisers Act, and collecting information regarding their private funds.

With the adoption of the Final Rules, the SEC has officially stretched its primary focus to bring private fund advisers (and, indirectly, private funds) that are exempt from registration more directly into their regulatory spotlight. The Final Rules represent the most significant increase in the SEC’s oversight over such private fund advisers since the initial registration requirement under Dodd-Frank.

We note that (similar to the Proposed Rules) many of the Final Rules align with the current third edition of the "ILPA Principles," a set of principles published in June 2019 by the Institutional Limited Partners Association (ILPA). For example, both the ILPA Principles and the Quarterly Statement Rule require the delivery of detailed financial disclosures, including the disclosure of fees and expenses paid by a fund and a fund's portfolio investments, to private fund investors on a quarterly basis. ILPA is an organization whose membership includes endowments, public and private pensions, foundations, and other institutional investors, and which encourages certain standardized disclosure and governance terms for private funds and private fund advisers.

Scope of Advisers Affected by the Final Rules

The scope of advisers subject to the Final Rules is largely unchanged from the Proposed Rules. The Final Rules apply, in relevant part as indicated herein, to registered investment advisers (RIAs), exempt reporting advisers (ERAs) and State registered or otherwise exempt advisers (SIAs).

In a change from the Proposed Rules, the Final Rules generally do not apply to advisers of "securitized asset funds" (SAFIAs), except with respect to the annual review of compliance policies as noted below.

Summary of the Final Rules

The Final Rules generally follow the substantive topics addressed in the Proposed Rules and would affect the relevant private fund advisers as summarized and indicated in the following:

Final Rule	**Topic of Final Rule**	**Affected Advisers**
211(h)(2)-1 (**Restricted Activities Rule**)	Restrictions on engaging in certain activities, including conflicts of interest and compensation schemes?, unless the adviser satisfies certain disclosure or consent conditions	RIAs, ERAs and SIAs
211(h)(2)-3 (**Preferential Treatment Rule**)	Preferential treatment or terms provided only to a subset ?of private fund investors are prohibited or permitted and subject to disclosure requirements	RIAs, ERAs and SIAs
211(h)(2)-2 (**Adviser-Led Secondaries Rule**)	Fairness opinion required for private fund adviser-led secondary transactions	RIAs
206(4)-10 (**Audit Rule**)	Mandatory audit of private fund financial statements to, among other things, serve as a check against misappropriation of assets and calculation of adviser fees	RIAs

(**Quarterly Statement Rule**) 211(c)(1)-2	investors – uniformity of fee presentation Delivery and content of quarterly statements to private fund	RIAs

Many private fund advisers already observe key practices and requirements implemented in the Final Rules, such as the delivery of annual audited fund financial statements to private fund investors. However, other matters have historically been the subject of lengthy contractual negotiations between private fund advisers and their investors, such as how and when a general partner's clawback obligation will be calculated or reduced. The Final Rules will undoubtedly create additional compliance costs and burdens, and in certain circumstances, we do not believe will result in greater investor protection.

Compliance Dates; Legacy Status

The Final Rules are effective as of November 13, 2023 (Effective Date). The SEC, however, has adopted various transition periods for the Final Rules, which are, in part, based on the amount of private funds assets managed by a particular adviser. Private fund advisers are expected to be in compliance with the Final Rules as of the end of the transition periods beginning on the Effective Date, as summarized below (Compliance Date).

The SEC provides for "legacy status" for certain existing funds from certain requirements under the Restricted Activities Rule and the Preferential Treatment Rule. Under the legacy status provisions, private funds that have commenced operations as of the applicable Compliance Date (Legacy Funds) are not required to amend certain governing agreements in place as of such Compliance Date if such amendment were necessary to comply with the applicable Final Rule. The SEC indicated that the "commencement of operations" includes any bona fide activity directed towards operating a private fund, including investment, fundraising or operational activity. Such activities include the issuance of capital calls, setting up a subscription facility, holding an initial closing, conducting due diligence on potential investments or making investments.

Final Rule	**Larger Private Fund Advisers**[1]	**Smaller Private Fund Advisers**[2]	**Legacy Status**
Restricted Activities Rule	12 months (November 2024)	18 months (May 2025)	Yes[3]
Preferential Treatment Rule	12 months (November 2024)	18 months (May 2025)	Yes[4]
Adviser-Led Secondaries Rule	12 months (November 2024)	18 months (May 2025)	None
Audit Rule	18 months (May 2025)	18 months (May 2025)	None
Quarterly Statement Rule	18 months (May 2025)	18 months (May 2025)	None

[1]Private fund advisers with $1.5 billion or more of “private fund assets under management”.?

[2] Private fund advisers with less than $1.5 billion of “private fund assets under management”.?

[3] Legacy status is available in respect of the restricted activities that require investor consent (i.e., restrictions on borrowing from any fund and charging for certain investigation fees and expenses). *See “***Restricted Activities Rule***”* below.

[4] Legacy status is available in respect of the prohibitions on providing preferential redemption or information reporting rights. *See “***Preferential Treatment Rule***”* below.

Restricted Activities Rule

The Proposed Rules included a list of “prohibited” activities. The Final Rules do not flatly prohibit such activities but instead generally restrict certain activities, unless certain disclosures are made to, or, in some cases, consent is obtained from, private fund investors. These restrictions relate to transactions involving conflicts of interest, compensation schemes and fund borrowing. Despite the SEC’s reclassification from “prohibited” to “restricted” activities, the SEC retained one prohibition regarding the allocation of certain investigation fees and expenses as noted below. The Final Rules otherwise allow for such activities so long as the adviser satisfies the applicable disclosure or consent conditions.

ERAs and SIAs should pay particular attention to these new requirements, as the substance of the Final Rules has not historically applied to them. The application of such substantive regulation to ERAs and SIAs represents a significant change in the regulatory obligations and burden for ERAs and SIAs. As originally contemplated under Dodd-Frank, ERAs and SIAs were not to be subject to substantive Federal regulation – other than general antifraud principles and “skinny” reporting requirements.

Under the Final Rules, the following activities/practices are restricted for any RIA, ERA or SIA, regardless of whether such activities/practices are permitted under a private fund’s governing documents, applicable state law, or contractual arrangements with investors.

Restricted Activity	Permissible Conditions and Additional Information

		Prohibited activity: Notwithstanding consent, an adviser may not charge or allocate such 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.
Charging Investigation, Compliance and Examination Expenses Rule 211(h)(2)-1(a)(1) Rule 211(h)(2)-1(a)(2)	Charging or allocating to a private fund any regulatory or compliance fees or expenses associated with an investigation of such adviser or its related persons by any governmental or regulatory authority.	Must provide written consent from investors of a majority in interest of the private fund's investors (other than related persons of the adviser) within 45 days after the end of the fiscal quarter in which the charge occurs. ***Legacy Status:*** Any Legacy Fund governance document that is in writing and in place as of the Compliance Date that
Reducing Clawbacks for Taxes Rule 211(h)(2)-1(a)(3)	Reducing the amount of a clawback obligation by actual, potential or hypothetical taxes applicable to the adviser or its related persons.	Must provide written notice to investors of the aggregate dollar amount of the reduction within 45 days after the end of the fiscal quarter in which the clawback occurs. The notice to investors may be provided as part of the quarterly statements delivered to investors (provided that the 45 day time period is met).
Certain Non-Pro Rata Fee and Expense Allocations Rule 211(h)(2)-1(a)(4)	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 the adviser or its related persons (other than a securitized asset fund) have invested (or propose to invest) in the same portfolio investment.	Non-pro rata charges or allocations must be fair and equitable under the circumstances. Must provide ***advance*** written notice to investors of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances. *See "Broken Deal Expenses" below.*

		governance document or loan agreement that is in writing and in place as of the Compliance Date that permits a private fund adviser to make such borrowings does not require investor consent and does not need to be amended.
Borrowing	Borrowing money, securities, or other	Must obtain written consent from at least a
Broken Deal Expenses	uses assets, or receiving a loan or an extension of credit, from a private fund client	majority-in-interest of the private fund's investors (that are not related persons of such adviser), and investments acquired

The SEC did not make a distinction between fees/expenses of consummated investments and unconsummated investments (i.e., "broken deal expenses"). In the Proposed Rules, the SEC stated that to the extent a potential co-investor does not have a binding obligation to participate in a transaction, the proposed borrowing would prohibit the allocation of expenses attributable to such potential co-investor to a private fund that would have participated in the transaction (subject to disclosure of such costs in the private fund's offering documents). The SEC did not provide any indication that this prior position was limited or changed in the Final Rules. As such, arrangements that provide for the allocation of broken deal expenses to a "main fund" are likely permissible under the Final Rules if properly disclosed and permitted under the applicable governing documents. However, advisers will still be required to disclose any broken deal expenses in quarterly statements, and the allocation of such expenses may still be subject to the "fair and equitable" standard under the Final Rules.

Proposed Adviser Misconduct Prohibitions

In the Final Rules, the SEC did ***not*** adopt their proposed prohibitions on advisers (a) charging a portfolio investment for monitoring, services, consulting, or other fees that the adviser does not, or does not reasonably expect to, provide to the portfolio investment, and (b) obtaining reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors related to a claim of breach of fiduciary duties, willful malfeasance, bad faith, negligence, or recklessness.

The SEC indicated that such prohibitions were unnecessary because such activities are generally contrary to an adviser's fiduciary duties and the antifraud provisions under the Advisers Act that are already applicable to advisers, including ERAs and SIAs. In addition, the SEC reiterated its position that an adviser's fiduciary duties under the Advisers Act cannot be waived by agreement and any such waiver would be a violation under the Advisers Act. The SEC explicitly notes that it does not take a position with respect to the scope or substance of any state law fiduciary duty. However, to the extent that any waiver clause is unclear as to whether such waiver applies to the Advisers Act fiduciary duty, state law fiduciary duty, or both, the SEC will interpret such clause as a waiver of the Advisers Act fiduciary duties. Therefore, advisers should evaluate any waiver, indemnification or exculpation clauses to clarify their application to avoid any foot-fault violations under the Advisers Act.

Preferential Treatment Rule

The Final Rules prohibit any RIA or ERA from granting preferential terms to an investor in any private fund that the adviser reasonably expects to have a material, negative effect on other investors in such private fund or a similar pool of assets managed by the adviser or its related persons, as set forth in the following:

Prohibited Preferential Terms	Exceptions
The ability for an investor to redeem its interest in such private fund	The ability to redeem is required by applicable law (foreign or domestic) to which such investor, the private fund or any similar pool of assets is subject. The adviser offers the same redemption ability to all other existing and future investors in such private fund or any similar pool of assets. ***Legacy Status:*** Any contractual agreement of a Legacy Fund that is in writing and in place as of the Compliance Date that grants preferential redemption rights does not need to be amended.
The provision of information about a private fund's holdings or exposure	The adviser offers such information to all other existing investors in such private fund and any similar pool of assets at the same time or substantially the same time. ***Legacy Status:*** Any contractual agreement of a Legacy Fund that is in writing and in place as of the Compliance Date that grants preferential information rights does not need to be amended.

Pursuant to the Preferential Treatment Rule, no RIA or ERA may grant a preferential term (including any preferential redemption or information reporting rights) to an investor in a private fund, unless the adviser provides the following notices, as applicable:

- Prospective Investors – written disclosure to each prospective investor in a private fund prior to such investor's investment in the private fund regarding any preferential treatment related to any material economic terms provided to other investors in the same private fund;
- Current Investors – written disclosure to each investor in a private fund of all preferential terms the adviser or its related persons has provided to other investors in the same private fund, (i) in respect of any private fund that is an illiquid fund, as soon as reasonably practicable following the of the private fund's fundraising period, and, (ii) in respect of any private fund that is a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund; and
- Annual Notices – written disclosure to each investor in a private fund on an annual basis of any preference terms provided to other investors in the same private fund during the preceding period.

In the release accompanying the Proposed Rules, the SEC stated that a determination of whether any term is "preferential" depends on the facts and circumstances. Advisers should consider consulting with counsel on determinations as to whether any term is preferential and any associated written disclosure. In adopting the Final Rules, the SEC recognized that the Preferential Treatment Rule will disrupt the fund closing process, but relied on speculative efficiencies and benefits to investors that may offset the increased difficulties experienced by advisers.

Adviser-Led Secondaries Rule

The Final Rules require an RIA, prior to completing an "adviser-led secondary transaction" with respect to a

private fund, to distribute the following to the private fund's investors prior to the due date of the investor election form in respect of such transaction: (a) a fairness opinion or valuation opinion from an independent opinion provider; and (b) a written summary of any material business relationships the adviser or any of its related persons has, or has had within the two years immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider.

Independent opinion providers are defined to include any entity that (a) provides fairness opinions or valuation opinions in the ordinary course of its business and (b) is not a "related person" of the adviser. The SEC specifically declined to allow for a broader group of opinion providers to meet the definition of independent opinion providers, noting the importance that opinion providers have the necessary experience to value assets in connection with adviser-led secondary transactions.

In its discussion accompanying the Proposed Rules, the SEC indicated that a wide scope of transactions may be covered by this rule, from single asset transactions to full fund restructurings. The Final Rules generally follow the substantive requirements as proposed by the SEC, except that an RIA may obtain a valuation opinion (as an alternative to a fairness opinion), and the deadline for making such required disclosures is based on the due date for the applicable investor election form in respect of any such transaction.

Audit Rule

The SEC declined to adopt the separate but similar audit requirements as previously proposed. The Final Rules require RIAs to cause each private fund they advise to undergo a financial statement audit in compliance with Advisers Act Rule 206(4)-2 (Custody Rule). The Audit Rule, in effect, supplants the Advisers Act surprise examinations alternative to satisfy the Custody Rule. Since most private funds do currently undergo an annual financial statement audit related to the Custody Rule, this portion of the Final Rules should have relatively little impact on advisers. For private funds that an RIA does not control – presumably this would most commonly be a situation where the RIA is a subadviser to the private fund — the Audit Rule requires an RIA to "take all reasonable steps" to cause any such private fund to (a) undergo an audit in compliance with Custody Rule and (b) deliver financial statements in accordance with the Custody Rule if the private fund does not otherwise undergo such audit.

Quarterly Statement Rule

The Final Rules require an RIA to cause its private fund clients to deliver quarterly statements to investors with minimum disclosures regarding fees, expenses and performance within (i) 45 days after the end of each of the first three fiscal quarters during each fiscal year and (ii) 90 days after the end of each fiscal year. For any private fund client that is a "fund of funds," the deadlines are extended to 75 days and 120 days, respectively.

The substantive reporting requirements under the Final Rules are substantially similar to those previously proposed by the SEC. As noted below, the performance disclosures vary in part on whether the private fund is an "illiquid fund" (defined in the Final Rules in relation to an investor's ability to withdrawal/redeem from such private fund, *e.g.*, a private equity fund) or a "liquid fund" (defined in the Final Rules as any private fund that is not a liquid fund, *e.g.*, a hedge fund).

Quarterly Statement Minimum Disclosures

Fund Table	A table for the private fund that discloses detailed accounting information, at the fund level, of the following, presented both before and after the application of any offsets, rebates, or waivers: • Fees/Compensation: all compensation, fees, and other amounts allocated or paid to the adviser or its related persons during the quarter, *with separate line items* for each category of allocation/payment, including management, advisory, or similar fees and performance-based compensation. • Expenses: all fees and expenses paid by the private fund during the quarter, *with separate line items* for each category of fee/expense, including but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses. • Offsets: The amount of any offsets or rebates carried forward during the quarter.
Portfolio Investment Table	A table for the private fund that discloses the following in respect of each portfolio investment: all advisory, monitoring, closing, administration, closing, disposition, directors, trustees, or similar fees or payments paid allocated or paid to the adviser or any of its related persons by or attributable to such portfolio investment during the quarter.
Performance	**Illiquid Funds:** the following performance measures must be disclosed, *calculated with and without the impact of any fund-level subscription borrowing facilities*: • Gross: internal rate of return (IRR) and multiple of invested capital (MOIC) for all investments calculated on a gross basis • Net: IRR and MOIC for all investments calculated on a net basis • Realized/Unrealized: gross IRR and MOIC separately calculated and displayed for realized and unrealized investments • Contributions/Distributions/NAV: A statement that sets forth (a) all capital contributions and distributions of the private fund since inception, with the value and date of each inflow and outflow, and (b) the net asset value of the fund as of the end of the quarter. **Liquid Funds:** • Annual net total returns for each fiscal year over the past 10 fiscal years or since inception, whichever time period is shorter • Average annual net total returns over the 1-, 5-, and 10-year fiscal year periods • Cumulative net total return for the current fiscal year, as of the end of the most recent fiscal quarter

	applicable calculation methodology.
Cross-References to Fund Organizational and Offering Documents	The quarterly statement must also include prominent disclosure of the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated and **include cross-references to the sections of the private fund's organizational and offering documents that set forth the**

Updating quarterly statement reporting practices and formats to reflect the required information under the Final Rules may present challenges and increased costs to advisers. Advisers should pay careful attention to calculations of performance information with respect to illiquid funds.

Annual Review of Compliance Policies

In addition to the private fund investor protections describe above, the Final Rules also amend rule 206(4)-7 under the Advisers Act to require *all* registered investment advisers (including SAFIAs and advisers those that do not advise private funds) to document the annual review of their compliance policies and procedures in writing. The Compliance Date for rule 206(4)-7 is November 13, 2023.

As we have in the past, we will continue to monitor these issues and will provide future client updates. This QuickStudy is for guidance only and is not intended to be a substitute for specific legal advice.

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