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SEC Adopts New Advisers Act Rules for Private Fund Advisers

WRITTEN BY

Joseph A. Goldman | Genna Garver

RELATED PROFESSIONALS

Paul A. Steffens | Julia D. Corelli | John M. Ford | Stephanie Pindyck Costantino | Genna Garver

On August 23, the Securities and Exchange Commission (SEC) adopted new rules (Adopting Release) for private fund advisers under the Investment Advisers Act of 1940, as amended (Advisers Act).[1] The new rules require private fund advisers to provide investors with quarterly reports and obtain annual audits of each private fund and fairness opinions or valuation opinions for adviser-led secondaries, while also restricting advisers from engaging in several practices.

According to the SEC's rule fact sheet[2], the reforms are designed to protect those direct and indirect private fund investors by increasing visibility into certain practices, establishing requirements to address practices that have the potential to lead to investor harm, and prohibiting or restricting adviser activity that is contrary to the public interest and the protection of investors.

The final rules include new Advisers Act Rules 206(4)-10, 211(h)(1)-1, 211(h)(1)-2, 211(h)(2)-1, 211(h)(2)-2, and 211(h)(2)-3, which are only applicable to private fund advisers. As discussed in greater detail below, several of these new rules apply not only to SEC-registered private fund advisers, but to all private fund advisers, including exempt reporting advisers. In addition to the new private fund rules, the SEC adopted amendments to existing Advisers Act Rules 204-2 (books and records) and 206(4)-7 (compliance procedures and practices), which apply not only to private fund advisers, but to all SEC registered advisers (and those required to be registered) — regardless of whether they have private fund clients.

Following significant industry pushback, the final version of the rules has been significantly modified from the proposal. *Please visit the following link to view and download a comparison of the text of the proposed rules against the final rules: https://www.troutman.com/wp-content/uploads/2023/08/Redline-Text-of-SEC-Private-Fund-Rules.pdf.*

Adopted Private Fund Adviser Rules

While several the new rules essentially codify industry best practices and SEC guidance, a few of the new requirements could increase private fund advisers' operating costs, particularly with respect to smaller private fund advisers.[3]

Definitions Rule – 211(h)(1)-1. New Rule 211(h)(1)-1 contains numerous definitions for purposes of the other

new rules adopted by the SEC and discussed below, including (but not limited to) the terms “adviser clawback,” “adviser-led secondary transaction,” “Gross IRR,” and “Gross MOIC.”

Quarterly Statements Rule – 211(h)(1)-2. *SEC Registered private fund advisers (and those required to be registered)* to a private fund (other than a securitized asset fund[4]) that has at least two full fiscal quarters of operating results must prepare and distribute a quarterly statement to the investor in those private funds, within 45 days after the end of each of the first three fiscal quarters of each fiscal year of the private fund and 90 days after the end of each fiscal year of the private fund[5]. Such statements must include certain standardized disclosures on the cost of investing in the private fund and the private fund’s performance. The quarterly statement also must include prominent disclosure on 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 applicable calculation methodology. Specifically, the statement must include:

- **Fund Table.** The following information must be presented both before and after the application of any offsets, rebates, or waivers:
  - A detailed accounting of all compensation, fees, and other amounts allocated or paid to the private fund adviser or any of its related persons by the private fund during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation;
  - A detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period (other than those listed above), with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and
  - The amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the private fund adviser or its related persons.

- **Portfolio Investment Table.** The quarterly statement must include a separate table for the private fund’s covered portfolio investments that discloses, at a minimum, the following information for each covered portfolio investment: a detailed accounting of all portfolio investment compensation allocated or paid to the private fund adviser or any of its related persons by the covered portfolio investment during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount, presented both before and after the application of any offsets, rebates, or waivers.

- **Performance Table.** The performance disclosure requirements require a private fund adviser first to determine whether its private fund client is an illiquid or liquid fund, as defined in the rule, no later than the time the private fund adviser sends the initial quarterly statement. Final Rule 211(h)(1)-1 defines “illiquid fund” as a private fund that (i) is not required to redeem interests upon an investor’s request, and (ii) has limited opportunities, if any, for investors to withdraw before termination of the private fund. “Liquid fund” is defined as any private fund that is not an illiquid fund. In the Adopting Release, the SEC noted that, generally, if a private fund allows voluntary redemptions/withdrawals, then it is a liquid fund. The SEC further noted that private funds that fall into the “illiquid fund” definition are generally closed-end funds that do not offer periodic redemptions/withdrawal options other than in exceptional circumstances (*e.g.*, most private equity and venture capital funds). The quarterly statement must present the following with equal prominence[6]:
  - For a liquid fund:
    - Annual net total returns for each fiscal year over the past 10 fiscal years or since inception, whichever time period is shorter;
    - Annual net total returns over the one-, five-, and 10-fiscal-year periods; and
    - The cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.
  - For an illiquid fund:
    - The following performance measures, shown since inception of the illiquid fund through the end of the

quarter covered by the quarterly statement and computed with and without the impact of any fund-level subscription facilities: (1) gross IRR and gross MOIC for the illiquid fund; (2) net IRR and net MOIC for the illiquid fund; and (3) gross IRR and gross MOIC for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately; and

- A statement of contributions and distributions for the illiquid fund.

Private Fund Audit Rule – 206(4)-10. *Private fund advisers registered or required to be registered with the SEC* must cause each private fund that they advise (other than a securitized asset fund), directly or indirectly, to undergo a financial statement audit (as defined in rule 1-02(d) Regulation S-X) that meets the requirements of limited partnership annual audits as set forth in the Custody Rule (Rule 206(4)-2(b)(4)) and must deliver audited financial statement in accordance with the Custody Rule (Rule 206(4)-2(c)), if the private fund does not otherwise undergo such an audit. For a private fund (other than a securitized asset fund) that the private fund adviser does not control and is neither controlled by nor under common control with, the private fund adviser will be prohibited from providing investment advice to the private fund if the private fund adviser fails to take all reasonable steps to cause the private fund to undergo a financial statement audit, and to cause audited financial statements to be delivered, in the same manner as discussed above.

On a related note, and in light of the Adopting Release, on August 23, the SEC reopened the comment period on its proposed rule that would amend and redesignate the current Custody Rule as the new Safeguarding Rule 223-1.[7] The reopened comment period will remain open until 60 days after the date of publication of the reopening release in the *Federal Register*.[8]

Adviser-Led Secondaries Rule – 211(h)(2)-2. *Private fund advisers registered or required to be registered with the SEC* conducting an adviser-led secondary transaction with respect to any private fund that it advises (other than a securitized asset fund) must meet the following requirements prior to the due date of the election form in respect of the adviser-led secondary transaction: (1) obtain and distribute to investors in the private fund, a fairness opinion or valuation opinion from an independent opinion provider; and (2) prepare and distribute, to investors in the private fund, a written summary of any material business relationships the private fund adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider.

For purposes of the rule, "adviser-led secondary transaction" means any transaction initiated by the private fund adviser or any of its related persons that offers private fund investors the choice between: (1) selling all or a portion of their interests in the private fund; and (2) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the private fund adviser or any of its related persons.

In a change from the proposed rule, the final rule gives private fund advisers the option to obtain and distribute a valuation opinion instead of a fairness opinion. In response to commenters' concerns about the cost of a fairness opinion, the SEC made the modification to include the valuation opinion option because "a valuation opinion would also provide a third-party check on valuation, which is critical to addressing the conflicts of interest inherent in adviser-led secondary transactions."[9]

Restricted Activities Rule – 211(h)(2)-1. In significantly departing from its proposal, the SEC modified its proposed rule that would have flatly prohibited certain activities, to restrict certain activities, subject to disclosure and consent requirements, which is more in line with historical practice. *All private fund advisers* ***— whether***

registered or exempt — with respect to private funds they advise (other than a securitized asset fund) are prohibited from, directly or indirectly:

- Charging or allocating to the private fund fees or expenses associated with an investigation of the private fund adviser or its related persons by any governmental or regulatory authority, unless the private fund adviser requests the written consent of each private fund investor and obtains such consent from at least a majority in interest of the private fund's investors that are not related persons of the private fund adviser; provided, however, a private fund adviser may not charge or allocate 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 thereunder;

- Charging or allocating to the private fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, of the private fund adviser or its related persons, unless the private fund adviser distributed a written notice of any such fees or expenses, and the dollar amount thereof, to the private fund investors within 45 days after the end of the fiscal quarter in which the charge occurs[10];

- Reducing the amount of a private fund adviser clawback by actual, potential, or hypothetical taxes applicable to the private fund adviser, its related persons, or their respective owners or interest holders, unless the private fund adviser sends written notice to the private fund investors that includes the aggregate dollar amounts of the clawback before and after any reduction for actual, potential, or hypothetical taxes within 45 days after the end of the fiscal quarter in which the clawback occurs;

- Charging or allocating fees or 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 private fund adviser or its related persons (other than a securitized asset fund) have invested (or propose to invest) in the same portfolio investment, unless (i) the non-pro rata charge or allocation is fair and equitable under the circumstances and (ii) prior to charging or allocating such fees or expenses to a private fund client, the private fund adviser distributed to each private fund investor a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances; and

- Borrowing money, securities, or other private fund assets, or receiving a loan or an extension of credit, from a private fund client, unless the private fund adviser: (i) distributed to each investor a written description of the material terms of, and requests each investor to consent to, such borrowing, loan, or extension of credit; and (ii) obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the private fund adviser.[11]

Notably, in a departure from the proposing release, the SEC followed the recommendation of its staff and did not adopt its proposed prohibition on fees for unperformed services because it believes charging such fees (including indirectly, by charging fees to a portfolio investment held by the fund) where the adviser does not, or does not reasonably expect to, provide such services already, is inconsistent with an adviser's fiduciary duty. The SEC also did not adopt its proposed waiver or indemnification prohibition, which as proposed, would have prohibited an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, *negligence*, or recklessness in providing services to the private fund. The SEC noted that most commenters opposed such a prohibition and that, after considering comments, an adviser's fiduciary duty to its private fund clients and the antifraud prohibitions under the Advisers Act are sufficient to address what the SEC referred to as a "problematic practice."[12] In the Adopting Release, the SEC reaffirmed and clarified its views on how an adviser's fiduciary duty applies to its private fund clients and how the antifraud provisions apply to the adviser's dealings with clients and fund investors. The SEC specifically stated that a waiver of an adviser's compliance with

its Federal antifraud liability for breach of its fiduciary duty to the private fund or otherwise, or of any other provision of the Advisers Act, or rules thereunder, is invalid under the Advisers Act. The final version of the rules also provides "legacy status" for certain existing private funds, which exempts advisers to those funds from compliance with the Restricted Activities Rule. See below for more on "legacy status."

Preferential Treatment Rule – 211(h)(2)-3. *All private fund advisers* — ***whether registered or exempt*** — are prohibited from, directly, or indirectly:

- Granting an investor in the private fund or in a similar pool of assets the ability to redeem its interest on terms that the private fund adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a similar pool of assets, except: (i) if such ability to redeem is required by the applicable laws, rules, regulations, or orders of any relevant foreign or U.S. Government, State, or political subdivision to which the investor, the private fund, or any similar pool of assets is subject; or (ii) if the private fund adviser has offered the same redemption ability to all other existing investors, and will continue to offer such redemption ability to all future investors, in the private fund and any similar pool of assets[13];

- Providing information regarding the portfolio holdings or exposures of the private fund, or of a similar pool of assets, to any investor in the private fund if the private fund 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 private fund adviser offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time;

- Providing any preferential treatment to any investor in the private fund unless the private fund adviser provides written notice as follows:
  - For prospective investors in a private fund, the private fund adviser must provide each prospective investor, prior to the investor's investment in the private fund, with a written notice that provides specific information regarding any preferential treatment related to any material economic terms that the private fund adviser or its related persons provide to other investors in the same private fund.
  - For current investors in a private fund, the private fund adviser must provide current investors with the following:
    - For an illiquid fund, as soon as reasonably practicable following the end of the private fund's fundraising period, written disclosure of all preferential treatment the private fund adviser or its related persons has provided to other investors in the same private fund;
    - For a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund, written disclosure of all preferential treatment the private fund adviser or its related persons has provided to other investors in the same private fund; and
    - On at least an annual basis, a written notice that provides specific information regarding any preferential treatment provided by the private fund adviser or its related persons to other investors in the same private fund since the last written notice.

Industry best practice is to not give preferential withdrawal or transparency rights in side letters, and to disclose the possibility of the private fund entering into side letters with certain investors to vary the terms of the private fund's governing documents with respect to that particular investor. However, the final rule requires advisers to make determinations as to whether preferential withdrawal and transparency rights have a material, negative effect on other investors, which may be challenging from a compliance perspective. Also, as Commissioner Pearce noted in her remarks during the open meeting, "conditioning preferential rights on offering them to everyone sounds like a ban on offering preferential rights, but the release does not characterize what we are doing as a ban."[14] The final rule also requires periodic notice of all specific side letter provisions. Notably, the final version of the rules provides "legacy status" for certain existing private funds, which exempts advisers to those

funds from compliance with the Preferential Treatment Rule. See below for more on “legacy status.”

Legacy Status. The SEC is providing “legacy status” for the prohibitions aspect of the Preferential Treatment Rule and the aspects of the Restricted Activities Rule that require investor consent. The legacy status provisions apply to governing agreements that were entered into prior to the compliance date if the rule would require the parties to amend such an agreement, and legacy status applies only to such agreements with respect to private funds that had commenced operations as of the compliance date.

Amended Books and Records Rule – 204-2

All SEC-registered private fund advisers (and those required to be registered) will be required to make and keep records relating to the following:

- Any notice required pursuant to the Preferential Treatment Rule, as well as a record of each addressee and the corresponding date(s) sent;
- A copy of any quarterly statement distributed pursuant to the Quarterly Statements Rule, along with a record of each addressee and the corresponding date(s) sent, and all records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any statement delivered pursuant to the Quarterly Statements Rule;
- For each private fund client: (i) a copy of any audited financial statements prepared and distributed pursuant to the Private Fund Audit Rule, along with a record of each addressee and the corresponding date(s) sent; or (ii) a record documenting steps taken by the private fund adviser to cause a private fund client that the private fund adviser does not control, is not controlled by, and with which it is not under common control to undergo a financial statement audit pursuant to the Private Fund Audit Rule;
- Documentation substantiating the private fund adviser’s determination that a private fund client is a liquid fund or an illiquid fund pursuant to the Quarterly Statements Rule;
- A copy of any fairness opinion or valuation opinion and material business relationship summary distributed pursuant to the Adviser-Led Secondaries Rule, along with a record of each addressee and the corresponding date(s) sent; and
- A copy of any notification, consent, or other document distributed or received pursuant to the Restricted Activities Rule, along with a record of each addressee and the corresponding date(s) sent for each such document distributed by the private fund adviser.

Amended Compliance Rule – 206(4)-7

The Adopting Release includes amendments to the Compliance Rule requiring *all SEC-registered advisers, **including those that do not advise private funds***, to document in writing the required annual review of their compliance policies and procedures. The SEC noted in the Adopting Release that the amendments will result in records of annual compliance reviews that allows the SEC staff to determine whether an adviser has complied with the review requirement of the Compliance Rule.[15] The amended Compliance Rule aligns the rule with Rule 38a-1 under the Investment Company Act of 1940, as amended, which requires registered fund CCOs to provide a written report to the registered fund’s board at least annually.

Compliance Dates

For the Private Fund Audit Rule and the Quarterly Statement Rule, the compliance date will be 18 months after the date of publication in the *Federal Register*. For the Adviser-Led Secondaries Rule, the Preferential Treatment Rule, and the Restricted Activities Rule, the compliance dates are: for advisers with $1.5 billion or more in private funds assets under management, 12 months after the date of publication in the *Federal Register*; and for advisers with less than $1.5 billion in private funds assets under management, 18 months after the date of publication in the *Federal Register*. Compliance with the amended Advisers Act compliance rule will be required 60 days after publication in the *Federal Register*.

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[1] *See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance*, SEC Release No. IA-6383 (Aug. 23, 2023), available at: https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.

[2] Available at https://www.sec.gov/files/ia-6383-fact-sheet.pdf.

[3] *See* Comment Letter from Lisa Crossley, NSCP Executive Director and CEO, National Society of Compliance Professionals (Apr. 19, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20124162-280557.pdf.

[4] The Quarterly Statement Rule, Private Fund Audit Rule, Adviser-Led Secondaries Rule, Restricted Activities Rule, and Preferential Treatment Rule do not apply to private fund advisers with respect to "securitized asset funds" they advise, which is defined as any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders. This definition is based on the corresponding definition for "securitized asset fund" in Form PF and Form ADV, and is designed to capture vehicles established for the purpose of issuing asset backed securities, such as collateralized loan obligations.

[5] If the private fund is a fund of funds, a quarterly statement must be distributed within 75 days after the end of the first three fiscal quarters of each fiscal year and 120 days after the end of each fiscal year.

[6] The quarterly statement must also include the date as of which the performance information is current through, and prominent disclosure of the criteria used and assumptions made in calculating the performance.

[7] *See*, Safeguarding Advisory Client Assets; Reopening of Comment Period, SEC Release No. IA-6384 (Aug. 23, 2023), available at: https://www.sec.gov/files/rules/proposed/2023/ia-6384.pdf; Safeguarding Advisory Client Assets, Release No. IA-6240 (Feb. 15, 2023), available at: https://www.sec.gov/files/rules/proposed/2023/ia-6240.pdf.

[8] For more information on proposed Safeguarding Rule 223-1, please see "Safekeeping of Client Assets," Genna Garver, *The Investment Lawyer*, July 2023. See also, "Breaking Down the New SEC Custody Rule Proposal," *Securities Compliance Podcast: Compliance in Context*, March 31, 2023.

[9] *See* Adopting Release, pg. 196.

[10] This prohibition will not apply with respect to contractual agreements governing a private fund that has

commenced operations as of the compliance date (as discussed below) and that were entered into in writing prior to the compliance date if such prohibition would require the parties to amend such governing agreements.

[11] This prohibition will not apply with respect to contractual agreements governing a borrowing, loan, or extension of credit entered into by a private fund that has commenced operations as of the compliance date (as discussed below) and that were entered into in writing prior to the compliance date if such prohibition would require the parties to amend such governing agreements.

[12] *See* Adopting Release, pgs. 256-58.

[13] This prohibition will not apply with respect to contractual agreements governing a private fund that has commenced operations as of the compliance date (as discussed below) and that were entered into in writing prior to the compliance date if such prohibition would require the parties to amend such governing agreements.

[14] See Commissioner Hester M. Peirce, Uprooted: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Aug. 23, 2023), available at: https://www.sec.gov/news/statement/peirce-statement-doc-registered-investment-adviser-compliance-reviews-08232023.

[15] *See* Adopting Release, pg. 302.

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