A Review of the SEC's Sweeping Final Private Fund Adviser Rules

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*The Securities and Exchange Commission (the "**SEC**") adopted on August 23, 2023, a final set of rules (the "**Final Rules**" or "**Rules**") under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), which are expected to have significant impact on the private funds industry. The Final Rules greatly increase the compliance requirements applicable to advisers to private funds who are registered, or required to be registered, with the SEC pursuant to the Advisers Act (collectively, "**RIAs**"). Exempt reporting advisers and state investment advisers who advise private funds are also subject to many, although not all, of the Final Rules. This bulletin is a follow-up to an earlier RPCK alert on the Final Rules and presents a more in-depth review and summary of the Final Rules, as well as an assessment of their implications for the private funds industry.*

KEY TAKEAWAYS

In adopting the Final Rules, the SEC amended two existing rules applicable to RIAs and adopted five new sets of rules referred to as the *Restricted Activities Rules*, *Preferential Treatment Rules*, *Audit Rules*, *Quarterly Statement Rules*, and *Adviser-led Secondaries Rules*. The applicability of the Rules and their compliance dates are discussed in summary fashion immediately below and discussed in further detail in the following section.

The following Rules are applicable **only** to **SEC-Registered Private Fund Advisers**:

Rule Category	Rule	Timetable for Compliance Following Publication of Rules in the Federal Register	
		Larger Advisers (Private Fund AUM ≥ $1.5B)	*Smaller Advisers (Private Fund AUM < $1.5B)*
Quarterly Statement Rules	Rule 211(h)(1)-2	18 months	18 months
Audit Rules	Rule 206(4)-10	18 months	18 months
Adviser-led Secondaries Rules	Rule 211(h)(2)-2	12 months	18 months
Books and Records Rules	Rule 204-2	See corresponding deadline for the rule whose compliance must be documented.	

The following Rule applies to **all SEC-Registered Advisers**, regardless of whether they advise private funds:

Rule Category	Rule	Timetable for Compliance Following Publication of Rules in the Federal Register *All Advisers*
Documentation of Annual Compliance Review	Rule 206(4)-7	60 days after publication

All Private Fund Advisers, including Exempt Reporting Advisers, state-registered advisers and others exempt from SEC-registration, are subject to the following Rules:

Rule Category	Rule	Timetable for Compliance Following Publication of Rules in the Federal Register	
		Larger Advisers (Private Fund AUM ≥ $1.5B)	*Smaller Advisers (Private Fund AUM < $1.5B)*
Restricted Activities Rules			
Charging Regulatory Fees and Expenses to a Private Fund	Rule 211(h)(2)-1	12 months	18 months
Non-Pro Rata Allocation or Charging of Fees and Expenses			
Borrowing from Private Funds			
Post-Tax GP Clawback			
Preferential Treatment Rules			
Redemption Rights	Rule 211(h)(2)-3	12 months	18 months
Transparency / Other Preferential Treatment			

Grandfathered ("Legacy Status") Funds

Existing funds are eligible for *limited* exemptions to the Final Rules under "grandfathering clauses". Private funds that commenced operations as of the applicable Rule's Compliance Date (see chart above) are exempt from certain portions of the Restricted Activities Rules and the Preferential Treatment Rules, listed

below, but only with respect to preexisting contractual commitments, provided that (1) such commitments were made in the private fund's governing documents, (2) those governing documents were entered into prior to the applicable Compliance Date, and (3) compliance with such Rules would require an amendment to such contractual commitments.

Rules Eligible for Legacy Status:

Subject to the requirements described above, the following Rules (or portions of Rules), each of which is discussed in detail later in this bulletin, are eligible for legacy status under "grandfathering clauses":

- Prohibitions, contained in Rule 211(h)(2)-3, on private fund advisers providing certain preferential redemption rights and information about portfolio holdings; and
- Restrictions, contained in Rule 211(h)(2)-1, on an adviser borrowing from a private fund or charging private funds for certain investigation fees and expenses (such grandfathering does not apply to the Rules prohibiting advisers from charging private funds for fees and expenses relating to an investigation that resulted in sanctions for a violation of the Advisers Act).

Application to Advisers to Securitized Asset Funds and Non-US Advisers

While the Final Rules generally apply only to private fund advisers, they require that all RIAs, regardless of whether they advise private funds, document an annual review of their compliance policies and procedures. Subject to this exception, the Rules do not otherwise apply to (1) advisers of securitized asset funds ("**SAFs**") with respect to the SAFs they advise, and (2) investment advisers without a principal office or place of business in the U.S. with respect to their non-US private funds, even if such funds have US investors.

BACKGROUND

The SEC initially published a set of proposed rules ("**Proposed Rules**"), approved by the Commission in a split 3-1 vote, on February 9, 2022, markedly expanding the regulation of private fund advisers in a move representing a notable departure from the SEC's longstanding disclosure- and principles-based approach to regulating the private funds industry. The stated purpose of the Proposed Rules was to increase investor protections, promote more efficient capital markets, and encourage capital formation in an increasingly important segment of the economy (currently representing approximately $23 trillion in assets). The SEC noted the growing significance of private funds in portfolios, not only of high-net--worth individuals and institutional investors, but also in those of investors who have indirect exposure to private funds through their participation in pension plans, endowments, foundations and certain other retirement plans which directly invest in private funds. The SEC observed a need to regulate certain activities engaged in by private fund advisers which have become commonplace, but which have the potential to disadvantage certain investor groups or portfolio companies of private funds.

The Proposed Rules provoked substantial feedback and comments from asset management industry groups, institutional investors, private fund advisers and others. In response, the SEC stepped back from some of its more controversial proposals. The Proposed Rules, for example, would have introduced outright prohibitions on several practices that have become commonplace in the fund management industry, including limiting carried interest clawbacks to after-tax distributions, allocating certain expenses

among related funds on an other-than-pro rata basis, and indemnifying and reimbursing the manager for costs of certain regulatory exams, investigations and enforcement proceedings involving the manager. In the Final Rules, the SEC opted to subject these practices to disclosure and consent requirements in lieu of imposing an outright prohibition.

As discussed above, the Final Rules apply, except as otherwise noted herein, to advisers to *"private funds"*, which, as defined by the SEC, primarily consist of pooled investment vehicles that are not required to register with the SEC as an investment company because they qualify for one or more exemptions under the Investment Company Act of 1940, most commonly on account of raising capital in a private offering from 100 or fewer investors (so-called 3(C)(1) Funds) or solely from investors who are qualified purchasers (so-called 3(C)(7) Funds).

DISCUSSION

*The following rules are applicable **only** to **SEC-Registered Private Fund Advisers** (section references are to the applicable section of Rules promulgated under the Advisers Act):*

Quarterly Statement Rules (Rule 211(h)(1)-2): RIAs must distribute to investors in the private funds that the advisers manage, quarterly financial statements within the following deadlines: 45 days after the end of each of the fund's first three fiscal quarters of the fund's fiscal year and 90 days after the end of each fiscal year of the fund. Such deadlines are extended (75 days and 120 days, respectively) for funds of funds (i.e., private funds with a strategy to invest in other investment funds). The requirement applies only once a private fund has had at least two full fiscal quarters of operating results. The required quarterly statements must disclose the following detailed information summarized in (a) through (d) below:

(a) *Fund Table*: The quarterly statement must include a table disclosing the following information, reported both prior to and after accounting for any offsets, rebates or waivers:

- A detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or its related persons during the quarter in accordance with the requirements set forth in the Rules;
- A detailed accounting of all fees and expenses allocated to or paid by the fund during the quarter, including without limitation, 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 quarter to subsequent periods to reduce future payments or allocations to the adviser or its related persons.

(b) *Portfolio Table*: The quarterly statement must include a separate table with a detailed accounting of all compensation allocated or paid to the adviser or its related persons by portfolio investments during the quarter, reported both prior to and after accounting for any offsets, rebates or waivers.

(c) *Calculations and Cross-References*: The quarterly statement must disclose the manner in which all expenses, payments, allocations, rebates, waivers and offsets are calculated and provide cross references to the relevant sections of the fund's organizational and offering documents that set forth the applicable calculation methodology.

(d) *Performance Information*: The quarterly statement must report performance information in terms of specified metrics corresponding to the status of the fund as either a "liquid" or "illiquid"

fund. Liquid funds include, for example, hedge funds and other funds that provide investors with a right to require the fund to redeem their interests in the fund. "Illiquid" funds include, for example, private equity and venture capital funds that provide investors with limited, if any, opportunities to withdraw before termination of the fund.

Each quarterly statement must use clear, concise, plain English and be presented in a format that allows comparison from one quarterly statement to the next.

Private Fund Audit Rule (Rule 206(4)-10):

RIAs must obtain audited financial statements, prepared in accordance with the Custody Rule (Rule 206(4)-2(b)(4)), for each of the private funds they advise, directly or indirectly, on an annual basis and upon liquidation of the fund. The statements generally must be prepared in accordance with U.S. GAAP and audited by an independent public accountant registered with and inspected by the Public Company Accounting Oversight Board (the **"PCAOB"**). The requirement that the fund's auditors be PCAOB-registered represents an enhanced standard (prior to the Final Rules no such general PCAOB-registration requirement for auditors of funds advised by RIAs existed), compliance with which will likely prove more burdensome and costly to RIAs advising private funds. The adviser must deliver copies of the audited financial statements to each investor in the private fund.

The Proposed Rule would have required, in essence, auditors of private fund financial statements to notify the SEC in the event that the auditor issues a private fund audit report containing a modified opinion or if the auditor resigns, was dismissed from or otherwise was terminated or removed from an audit engagement with a private fund. The SEC did not include this requirement in the Proposed Rules; however, the notification requirement was included in the proposed amendments to the Custody Rule, and the SEC is currently separately considering comments on this requirement.

Adviser-led Secondaries (Rule 211(h)(2)-2):

RIAs who advise private funds are required, with respect to any secondary transactions they may conduct:

- To obtain, and distribute to investors in the private fund, a fairness opinion or valuation opinion from an independent opinion provider, and
- To prepare, and distribute to investors in the private fund, a written summary of any material business relationships the adviser or its related persons has, or has had within the 2-year period prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider.

The foregoing must be distributed to investors prior to the due date of the election form issued to investors soliciting their participation in the adviser-led secondary transaction. The SEC defines an *"adviser-led secondary transaction"* as any transaction initiated by the adviser or any of its related persons that offers the private fund's 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 adviser or any of its related persons.

Books and records (Rule 204-2): The Final Rules amend the Advisers Act's recordkeeping rule to require RIAs to retain books and records relating to compliance with the Quarterly Statement Rule, the Audit Rule, the Adviser-led Secondaries Rule, the Preferential Treatment Rules, and the Restricted Activities Rule.

***All* SEC-Registered Advisers**, *regardless of whether they advise private funds, are subject to the following Rule:*

Documentation of Annual Compliance Review (Rule 206(4)-7):

The Final Rules require that all RIAs, regardless of whether they advise private funds, in addition to conducting an annual review of the adequacy of their compliance policies and procedures pursuant to the existing Rule 206(4)-7, document this annual compliance review in writing.

***All* Private Fund Advisers**, *including Exempt Reporting Advisers, state-registered advisers and other advisers exempt from SEC-registration, are subject to the following Rules:*

Restricted Activities Rules (Rule 211(h)(2)-1)

Charging Regulatory Fees and Expenses to a Private Fund:

Charging Certain Fees Permitted with Disclosure. Under the Final Rules, advisers are generally prohibited from charging or allocating to a private fund regulatory, compliance, or examination fees or expenses of the adviser or its related persons unless the adviser distributes to investors in the private fund a written notice of any such fees or expenses. The disclosure must be distributed to investors of such private fund in writing within 45 days after the end of the fiscal quarter in which the charge occurs, must state the total dollar amount of such fees and expenses, and must contain sufficient detail to notify investors of the nature of the fees and expenses (i.e., rather than describing such fees generically so as to conceal their true nature and extent). The adviser is not otherwise required to specify whether such fees or expenses are related to the fund's activities or the adviser's activities.

Charging Certain Fees Permitted with Consent. Under the Final Rules, advisers are prohibited from charging or allocating to a private fund fees and expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, *unless the adviser obtains the written consent* of at least a majority in interest of investors in the fund who are not related persons of the adviser.

Charging Certain Fees Strictly Prohibited. Under the Final Rules advisers are prohibited altogether (i.e., regardless of whether disclosure is made or consent is received) from charging or allocating to a private fund fees and expenses of an investigation that results in a court or governmental authority imposing a sanction for a violation of the Advisers Act or the rules promulgated thereunder.

Non-pro rata allocation or charge of fees and expenses: Private fund advisers are prohibited under the Final Rules from charging or allocating fees or expenses related to actual or potential portfolio investments on a non-pro rata basis to multiple private funds or clients advised by the private fund adviser or its related persons unless: (1) such non-pro rata charge or allocation is fair and equitable under the circumstances. and (2) prior to charging or allocating such fees or expenses to a private fund, the adviser delivers to each investor in the private fund a written notice of the non-pro rata charge and a description of how such sharing is fair and equitable under the circumstances.

Borrowing from Private Funds: The Final Rules prohibit a private fund adviser from borrowing money, securities or other assets or receiving a loan or extension of credit from a private fund client unless the adviser (1) distributes to each investor a written description of the material terms of, and requests each

investor to consent to, such borrowing, and (2) obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser.

Post-tax GP Clawback: Private fund advisers are prohibited under the Final Rules from reducing the amount of any carried interest or other performance compensation clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons or their respective owners or interest holders. Advisers are excused from the foregoing prohibition if they distribute to investors of the applicable private fund a written notice which sets forth the aggregate dollar amounts of the adviser clawback before and after any reduction for taxes within 45 days of the end of the fiscal quarter in which the adviser clawback subject to the tax deduction occurs.

Preferential Treatment Rules (Rule 211(h)(2)-3)

Redemption Rights: : Under the Final Rules, a private fund adviser may not grant an investor in a private fund or in a similar pool of assets advised by such adviser the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in the private fund or similar pool of assets *subject to the following limited exceptions*:

(a) the investor's ability to redeem is required by applicable laws, rules, regulations or orders of any relevant foreign, US or state government or political subdivision to which the investor, the private fund or any similar pool of assets is subject. Advisers who rely on this exemption still must disclose the terms of the redemption right pursuant the Transparency / Other Preferential Treatment rule (Rule 211(h)(2)-3(b)), discussed below. A redemption right that is required by an investor's internal policies, procedures, or resolutions is not permitted under this exemption.

(b) the investment adviser has offered the same redemption rights, without qualification, to all other existing investors and will continue to offer such rights to all future investors in the private fund, again, without qualification. Thus, redemption rights granted pursuant to this exemption must not be subject to commitment size thresholds, affiliation requirements or other limitations.

A "similar pool of assets" is defined in the Final Rules as a pooled investment vehicle (other than registered investment companies and SAFs) with "substantially similar investment policies objectives, or strategies to those of the private fund managed by the investment adviser or its related persons."

The impact that the prohibition on redemption rights will have on market practice vis-à-vis certain categories of private fund investors that have customarily requested and received redemption rights from private fund advisers (such as development finance institutions and private foundation investors making "program related investments" in private funds) is a developing issue and one that we anticipate will be the subject of a separate future RPCK bulletin.

Transparency:

Private fund advisers are further prohibited under the Final Rules from providing preferential information rights 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 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, *unless* such information right is offered to all investors in the private fund and any similar pool of assets.

Other Preferential Treatment:

The Final Rules prohibit an adviser to a private fund from, directly or indirectly, providing any preferential treatment (e.g., in a side letter) to any investor in the private fund unless the adviser provides the following written notices:

- *Advance Written Notice to Prospective Investors in the Private Fund:* The written notice must provide specific information about any preferential *material economic terms* that the adviser or its related persons provide to other fund investors. This requirement raises a number of questions around how compliance by advisers of private funds with this advance disclosure obligation will impact and change the manner in which advisers and prospective limited partners negotiate side letter arrangements. We anticipate a future RPCK bulletin focusing in on this issue in greater detail.

- *Written Notice to Current Investors in the Private Fund*: Written disclosure of *all preferential treatment* must be provided to other existing investors in the same private fund, in the case of illiquid funds (defined above), as soon as reasonably practicable following the end of the fund's fundraising period, and, in the case of liquid funds, as soon as reasonably practicable following the investor's investment in the private fund.

- *Annual Notice to Current Investors:* At least annually, written notice must be provided to current fund investors providing specific information regarding any preferential treatment provided to other fund investors since the last written notice provided by the adviser.

Notably, the advance written notice requirement applies only to preferential material economic terms, rather than all preferential terms.

The requirement to disclose preferential terms to all investors, without regard to the size of the investor's commitment or other qualifying factors, can be expected to influence the way in which advisers to private funds conduct MFN or "most favored nations" processes and draft related provisions in investor side letters. We anticipate a future RPCK bulletin focusing on this issue in greater detail.

Implications of the Private Fund Rules

We anticipate that the Final Rules will prompt significant changes in the private funds industry. As noted above, the Rules represent a significant expansion of the compliance requirements applicable to private fund advisers. Such advisers, and, to a limited extent, all RIAs, will need to review their current practices, policies and documentation to evaluate the changes that may be required to comply with the Final Rules and/or with the corresponding industry best practices that develop as the rules are implemented. Investors and current and prospective portfolio companies of private funds should be aware of the Final Rules and the corresponding changes in industry practices that develop as the Rules are implemented. We

also anticipate that the SEC and industry practitioners will issue noteworthy guidance on the Rules in the months ahead.

RPCK's lawyers are available to assist with any questions you may have regarding the Final Rules and their implications and requirements. Please contact the RPCK attorney with whom you usually work in RPCK's investment funds practice group or Tom Scriven, Senior Counsel and head of RPCK's Denver office at tom.scriven@rpck.com or (720) 778-3062 or Aaron Bourke, head of RPCK's Fund Formation practice group, at aaron.bourke@rpck.com or (212) 594-9600.