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SEC Enhances Regulation of Private Fund Advisers

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US

Overview

On August 23, 2023, the Securities and Exchange Commission (SEC) adopted significant new rules for private fund advisers.¹ The SEC finalized the changes along party lines with all three Democratic commissioners in favor and the two Republican commissioners opposed. Certain aspects of the new rules will apply to all private fund advisers, not only those registered with the SEC.² In addition, the finalized package includes amendments to the Investment Advisers Act of 1940 (Advisers Act) compliance program rule that will impact all registered investment advisers. The final rules come as the industry is awaiting other major rules packages from the SEC, including rules impacting cybersecurity, open end fund liquidity risk management programs and swing pricing, vendor oversight by investment advisers, and environmental, social, and governance (ESG) practices.

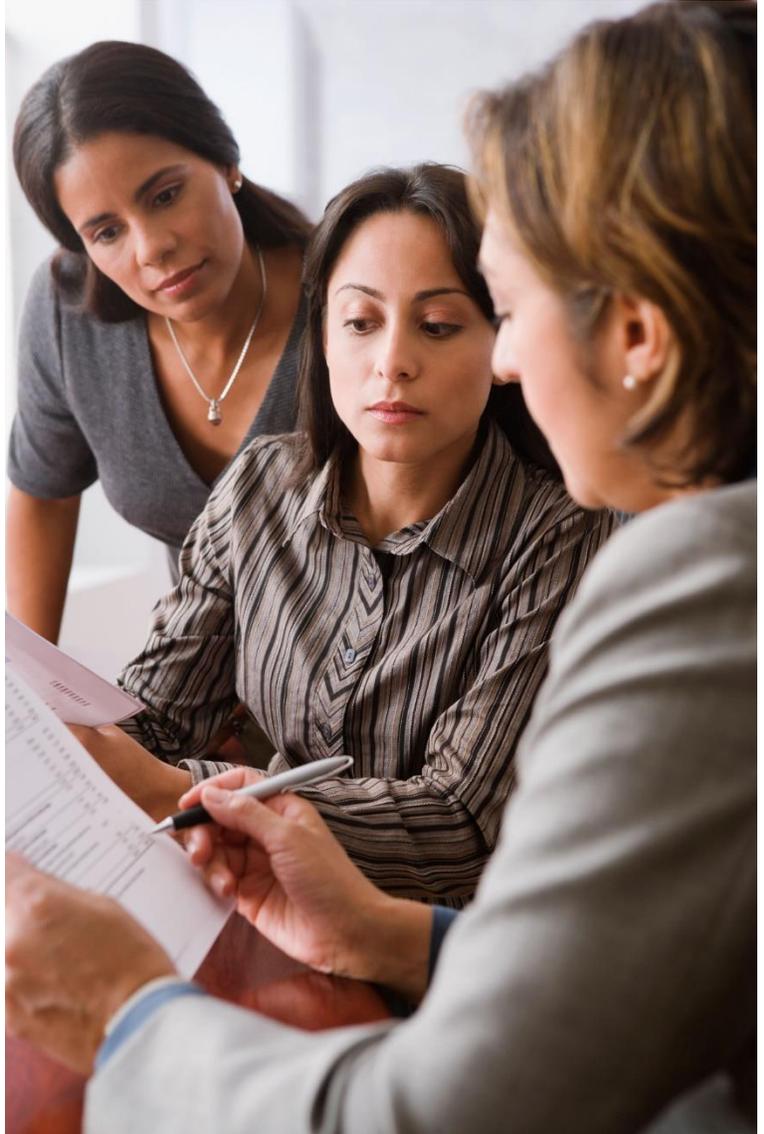


Table 1: Summary of final rules and amendments

Table 1 summarizes the major components of this sweeping new rules package, who is impacted, and associated compliance timelines.

For registered private fund adviser ³	Impacted advisers and key components of the final rule	Compliance timeline
	<p>Quarterly statement rule: Registered private fund advisers (PFAs) are required to prepare a quarterly statement for any private fund (other than a securitized asset fund) that it advises that has at least two full fiscal quarters of operating results that includes performance information, costs associated with investing in the fund, and fees and expenses paid by and allocated to the fund. The rule includes a provision requiring advisers to consolidate the quarterly reporting to cover similar pools of assets if doing so would provide more meaningful information to fund investors. For example, the rule requires the adviser to provide feeder fund investors with a single quarterly statement covering the applicable feeder fund and the feeder fund's proportionate interest in the master fund on a consolidated basis, so long as the consolidated statement provides more meaningful information to investors and is not misleading.</p> <p>Under the final rule, funds are classified as liquid or illiquid. For liquid funds, the rule requires an adviser to display (1) the annual net total returns for each fiscal year over the past 10 years (or since the fund's inception, whichever is shorter); (2) average annual net total returns over the one-, five-, and 10-year periods; and (3) cumulative net total return for the current fiscal year. For illiquid funds, advisers must present since inception the (1) gross and net internal rate of return (IRR); (2) gross and net multiple of all invested capital (MOIC); and (3) gross IRR and MOIC for the realized and unrealized portions of the portfolio, with realized and unrealized performance shown separately. Illiquid funds also need to calculate each performance measure with and without the impact of subscription facilities. Illiquid fund quarterly statements must also include a statement of contributions and distributions.⁴ The adviser must disclose the use of any assumptions and criteria used for calculating performance in the quarterly statement.</p> <p>Quarterly statements for a private fund must be distributed to the private fund's investors within 45 days after the first three fiscal quarters and 90 days after the end of the fiscal year of the private fund. If the private fund is a fund of funds, then a quarterly statement must be distributed within 75 days after the first three fiscal quarters and 120 days after the end of the fiscal year.</p>	<p>18 months after date of publication in the Federal Register</p>
	<p>Private fund audit rule:⁵ Registered private fund advisers are required to obtain financial statement audits for their private fund clients (other than securitized asset funds) from a PCAOB-registered independent public accountant that is subject to regular inspection in accordance with the Advisers Act custody rule.</p> <p>Auditors will not be required to notify the SEC in connection with an audit report that contains a modified opinion. However, the SEC has proposed similar notification requirements in the proposed amendments to the custody rule.⁶</p>	<p>18 months after date of publication in the Federal Register</p>
	<p>Adviser-led secondaries rule: Registered private fund advisers are required to obtain a fairness opinion or a valuation opinion from an independent opinion provider when engaging in "adviser-led secondary transactions" and distribute the opinion to private fund investors prior to the due date of the election form. Within that same timing, advisers are also required to disclose and distribute to private fund investors a written summary of any material business relationships⁷ with the independent opinion provider during the two years immediately prior to the issuance date of the fairness opinion or valuation opinion.</p>	<p>12 months after date of publication in the Federal Register for PFAs with \$1.5 billion or more in private funds AUM; 18 months for those with less than \$1.5 billion private funds AUM</p>
	<p>Books and records rule: Advisers are required to keep records related to the new rules and substantiating their compliance, including, among other things, copies of (1) quarterly statements and audited financial statements, including a record of each addressee and the corresponding date(s) sent; (2) all records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on quarterly statements; and (3) documentation that substantiates the adviser's conclusions that a private fund is liquid or illiquid.</p>	

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	Impacted advisers and key components of the final rule	Compliance timeline
For all private fund advisers ³	<p>Restricted activities rule: The rule restricts private fund advisers from engaging in certain activities unless they meet specific disclosure conditions and, in certain instances, obtain consent, including (1) charging or allocating fees or expenses to the private fund for an investigation being conducted on the adviser or its related persons by any governmental or regulatory authority⁸; (2) charging or allocating fees or expenses to the private fund related to compliance or associated with an examination of the adviser or its related persons; (3) reducing the amount of any adviser claw back by taxes (whether actual, potential, or hypothetical) applicable to the adviser, its related persons, or their respective owners or interest holders; (4) charging or allocating fees or expenses related to a portfolio investment on a non-pro rata basis when more than one private fund or other client advised by the adviser or its related persons (other than a securitized asset fund) have invested (or propose to invest) in the same portfolio company; and (5) borrowing or receiving a loan or an extension of credit from a private fund client.</p>	12 months after date of publication in the Federal Register for PFAs with \$1.5 billion or more in AUM; 18 months for those with less than \$1.5 billion AUM
	<p>Preferential treatment rule: The rule restricts private fund advisers (other than with respect to a securitized asset fund) from engaging in any of the following activities, whether directly or indirectly:</p> <ul style="list-style-type: none"> • Granting an investor in the private fund or in a similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors, unless: (1) the ability to redeem is required by applicable laws, regulations, or government orders, or (2) when the same redemption ability is extended to existing and future investors in the same fund or similar asset pools. • Providing information regarding portfolio holdings or exposures of the private fund or a similar pool of assets to any private fund investor if the adviser reasonably expects providing such information would have a material, negative effect on other investors of the private fund or similar pool of assets unless made available to all other investors in the fund or similar pool of assets at the same or substantially the same time.⁸ • Providing, directly or indirectly, any preferential treatment related to any “material economic terms” to any investor in a private fund (other than a securitized asset fund) unless the adviser provides advance written notice of specific information, regarding said preferential treatment, in writing to prospective investors prior to their investment in the fund. For current investors, this information must be provided on at least an annual basis.⁹ 	12 months after date of publication in the Federal Register for PFAs with \$1.5 billion or more in private funds AUM; 18 months for those with less than \$1.5 billion private funds AUM
	<p>Legacy Status - Certain private fund relationships have been granted legacy status under the preferential treatment rule restrictions and from certain portions of the restricted activities rule, which are summarized above. The legacy status provisions would apply to a fund's governing agreements that were entered into prior to the compliance date if the preferential treatment rule or the restricted activities rule would require the parties to amend such a governing agreement.¹⁰</p>	
For all registered advisers	<p>Compliance rule: The amendment to rule 206(4)-7 establishes a written documentation requirement related to the registered adviser's annual compliance program review. The amended rule requires all registered investment advisers, including those that do not advise private funds, to document in writing, the annual review of their compliance policies and procedures and the effectiveness of their implementation.</p>	60 days after publication in the Federal Register

Table 2: Directional change of compliance requirements

Table 2 illustrates the directional impact of the final requirements as compared to existing requirements and the 2022 proposal.

Rule component	Change from existing requirements	Change from proposal	Estimated implementation effort
Quarterly statements			
Private fund audit			
Adviser-led secondaries			
Books and records amendments			
Restricted activities			
Preferential treatment			
Compliance rule amendments			

CHANGE	Yes	Increase	Decrease	No material change
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ESTIMATED EFFORT	High	Medium	Low
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Next steps for firms

While the full scope of operational impacts from these rules will be better understood in the coming weeks and months, there are some immediate actions that firms can take to begin assessing and preparing for compliance with the final rule, including conducting a gap assessment of their current policies and procedures against the requirements of the new rules.

Rule component	Next steps	Entity type
Quarterly statements	<ul style="list-style-type: none"> • Begin to identify and catalogue sources of information required to be reported in quarterly statements • Develop processes and controls for creation, review, and distribution of quarterly statements • Reevaluate methodologies and processes utilized to allocate “shared” expenses across private funds • Review methodologies and assumptions utilized to calculate net total returns of liquid funds and calculate performance measures of illiquid funds (e.g., (1) gross and net IRR and MOIC since inception; (2) gross IRR and MOIC returns with realized and unrealized performance shown separately; and (3) all performance measures with and without subscription facilities) • Assess data retention needs • Identify potential vendors, if necessary, to assist with quarterly statement preparation and/or distribution 	For registered private fund advisers
Private fund audit	<ul style="list-style-type: none"> • Identify funds requiring annual audit (evaluate foreign funds, special purpose vehicles, and funds currently utilizing a surprise exam for compliance with the custody rule) • Identify PCAOB-registered auditors subject to inspection 	For registered private fund advisers
Adviser-led secondaries rule	<ul style="list-style-type: none"> • Identify independent party to provide fairness or valuation opinions • Identify material business relationships the adviser has with the independent fairness or valuation opinion provider • Develop a process for the distribution of a fairness/valuation opinion and a summary of material business relationships 	For registered private fund advisers
Restricted activities	<ul style="list-style-type: none"> • Identify and categorize all restricted activities • Document and maintain an inventory of all related persons of the investment adviser • Consider whether there are restricted activities that can be performed within exceptions granted by the rule • Identify activities requiring notice and consent requirements and develop related processes and templates 	For all private fund advisers
Preferential Treatment	<ul style="list-style-type: none"> • Identify all side letters or legacy agreements, including those with potentially preferred redemptions or information rights that would have a material negative effect on other investors • Identify preferential treatments (including definitional elements) requiring consent and develop related processes and templates 	For all private fund advisers
Compliance	<ul style="list-style-type: none"> • Be prepared to document and retain in writing the required annual review of compliance policies and procedures 	For all registered advisers

Endnotes

¹ Securities and Exchange Commission, "[Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews](#)," August 23, 2023.

² The adopting release notes that all elements of the final rule generally do not apply with respect to the non-U.S. private fund clients of an offshore adviser (regardless of whether they have U.S. investors).

³ The quarterly statement, restricted activities, adviser-led secondaries, preferential treatment, and audit rules do not apply to investment advisers with respect to securitized asset funds that they advise.

⁴ The SEC has defined 'statement of contributions and distributions' as a document that presents: (i) All capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund's inception, with the value and date of each inflow and outflow; and (ii) The net asset value of the private fund as of the end of the reporting period covered by the quarterly statement.

⁵ For a private funds that an adviser does not control, the adviser may not provide investment advice to the private fund unless it takes all reasonable steps to cause the private fund to undergo a financial statement audit that meets the requirements of the rule.

⁶ Securities and Exchange Commission, "[Safeguarding Advisory Client Assets](#)," August 23, 2023.

⁷ Per the adopting release, whether a business relationship is material requires a facts and circumstances analysis; however, for purposes of the rule, audit, consulting, capital raising, investment banking, and other similar services would typically meet this standard.

⁸ Allocation of fees and expenses related to an investigation that results in sanctions for a violation of the Investment Advisers Act are prohibited, however.

⁹ Written notice for current investors must be provided at the end of fundraising period for illiquid funds and "as soon as reasonably practicable" for liquid funds.

¹⁰ Legacy status only applies if a private fund has commenced operations as of the compliance date. The SEC has provided examples of what it considers bona fide activity that is consistent with a fund's commencement of operations on page 317 of the adopting release.

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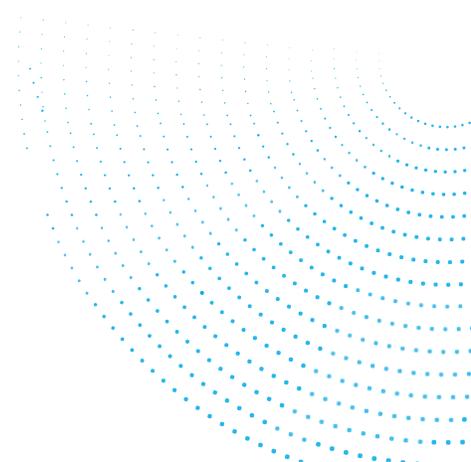
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Center for Regulatory Strategy US

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