SEC Adopts Rules to Enhance Private Fund Disclosures and Limit Certain Private Fund Adviser Activities

August 24, 2023

On August 23, 2023, the Securities and Exchange Commission (the *"Commission"*) voted 3 to 2 to adopt new and amended rules (available here) under the Investment Advisers Act of 1940 (the *"Advisers Act"*) requiring advisers to private funds to provide additional disclosures to investors in such funds, restrict certain types of preferential treatment to investors, and impose new requirements related to fund audits, books and records, and adviser-led secondary transactions.

Specifically, the final rulemaking will:

- Require registered private fund advisers to provide investors with quarterly statements including information about fund performance, fees, and expenses.
- Require registered private fund advisers to obtain an annual audit of each advised fund conducted by an independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board.
- Require registered private fund advisers, in connection with an adviser-led secondary transaction, to obtain and distribute to investors a fairness opinion or a valuation opinion and a written summary of certain material relationships between the adviser and the opinion provider.
- Restrict **all** private fund advisers (whether registered or not) from engaging in certain activities and practices described by the Commission as "contrary to the public interest and the protection of investors" unless the adviser provides appropriate specified disclosure and, in some cases, obtains investor consent. The restricted activities, along with the applicable exceptions, are as follows:

Restriction	Exception
Charging or allocating to the private fund fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority.	An adviser seeks consent from all investors of a private fund, and obtains written consent from at least a majority in interest of the fund's investors that are not related persons of the adviser, for charging the private fund for such investigation fees or expenses; however, regardless of any disclosure or consent, an adviser may not charge or allocate fees and expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for violating the Advisers Act or the rules promulgated 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 adviser or its related persons.	An adviser distributes a written notice of any such fees or expenses, and the dollar amount thereof, to investors on at least a quarterly basis.
Reducing the amount of an adviser clawback by the amount of actual, potential or hypothetical taxes.	An adviser satisfies certain disclosure requirements intended to inform investors of the impact of after-tax adviser clawback reductions.

Restriction	Exception
Charging fees or expenses (including broken deal expenses) related to an actual or proposed portfolio investment on a non-pro rata basis.	Prior to charging or allocating such fees or expenses to a private fund client, the investment adviser distributes to each investor of the private fund a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances.
Borrowing or receiving an extension of credit from a private fund client.	The adviser distributes a written notice and description of the material terms of the borrowing to the investors, seeks their consent for the borrowing, and obtains written consent from at least a majority in interest of the fund's investors that are not related persons of the adviser.

- Restrict all private fund advisers from providing preferential liquidity terms or portfolio holdings or exposure information terms to certain investors (such as through a side letter agreement) that may have a material negative effect on other investors, subject to certain limited exceptions.
- Restrict all private fund advisers from providing preferential treatment to certain investors and not others unless:
  - Prior to an investor's investment in the private fund, the adviser provides a written notice to such investor that discloses specific information regarding any preferential treatment related to any material economic terms that the adviser or its related persons have granted to other investors in the same fund.
  - The adviser provides current investors with:
    - For an illiquid fund (*e.g.,* a closed-end fund), as soon as reasonably practicable following the end of the private fund's fundraising period, written disclosure of **all** preferential treatment the adviser or its related persons have provided to other investors in the same fund.
    - For a liquid fund (*e.g.,* a hedge fund), as soon as reasonably practicable following the investor's investment in the private fund, written disclosure of all preferential treatment the adviser or its related persons have provided to other investors in the same private fund.
    - On at least an annual basis, a written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided in accordance with the rule, if any.
- Require advisers who are registered or required to be registered to retain books and records related to the quarterly statement rule, the audit rule, the adviser-led secondaries rule, the restricted activities rule, and the preferential treatment rule.
- Require all registered advisers, **including those that do not advise private funds**, to document the annual review of their compliance policies and procedures in writing.

Changes From the Proposed Rules

The final rules have several important changes from the original February 2022 proposal. Among the more significant of those changes are the following:

- **Prohibition on Indemnification for Certain Conduct.** The proposed rules would have prohibited an adviser from seeking reimbursement, indemnification, exculpation, or limitation of its liability for certain

conduct, including breaches of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to a private fund. The Commission explained that it believes a prohibition is not necessary to achieve its goals to address this problematic practice because such practices may already be counter to (and therefore possibly prohibited by) an adviser's federal fiduciary duty and the Advisers Act antifraud provisions.

- **Auditor Notification.** The proposed requirement for private fund independent public accountants to notify the Commission upon issuing an audit report to a fund that contains a modified opinion or upon its resignation, termination, or removal from consideration of being reappointed as a fund's auditor was not included in the final rules. However, the Commission recently proposed amendments to the Advisers Act custody rule (which would require advisers to enter into a written agreement with the independent public accountant performing the audit) that would effectively require the same notification (for more information on this and the other proposed custody rule amendments, please see our Client Alert available here).

- **Valuation Opinion.** In connection with the adviser-led secondaries rule, the final rule provides that advisers may obtain a fairness opinion or a valuation opinion, whereas the proposed rule only contemplated a fairness opinion.

- **Fees for Unperformed Services.** The proposed rules would have prohibited charging certain fees and expenses to a private fund or its portfolio investments, such as fees for unperformed services (*e.g.,* accelerated monitoring fees) and fees associated with an examination or investigation of the adviser by any governmental or regulatory authority. The final rules eliminated this prohibition, with the Commission explaining that it believes payment for services an adviser does not reasonably expect to provide are already prohibited by an adviser's federal fiduciary duty.

- **Disclosure and Consent Exception to Prohibited Activities.** In a departure from the proposed rules, each of the adviser prohibited activities are now "restricted" activities that may be permitted where an adviser provides appropriate specified disclosure and, in some cases, obtains investor consent.

- **Preferential Liquidity Exceptions.** While the final rules adopted the restriction on the granting of preferential liquidity rights substantially as proposed, the final rules included exceptions if the liquidity right is required by law or is offered to all investors Notably, the "required by law" exception does not on its face appear to permit preferential liquidity terms necessary to maintain certain tax or regulatory status, such as treatment as a foundation under federal tax laws.

- **Preferential Information Exceptions.** Similar to the exception to the restriction on preferential liquidity rights, an exception to the restriction on preferential information rights exists for information that is offered to all other existing investors. Notably, the Commissioners acknowledged the similarities between this exception and Regulation FD under the Securities Exchange Act of 1934.

- **Preferential Treatment Generally.** The general prohibition on providing preferential terms without disclosure to current and future investors was changed in three ways:

  - First, the requirement to provide investors with disclosure of preferential treatment in advance of their investment was limited from "all preferential treatment" to "any preferential treatment related to any material economic terms."

  - Second, whereas the proposed rule would have required disclosure of all preferential treatment in advance of a new investment, the final rule requires advisers to disclose all preferential treatment to current investors on a timeline determined by the type of fund (as described above).

  - Third, the final rule applies the preferential treatment disclosure obligations to all preferential treatment and makes clarifying changes to remove the implication that preferential treatment for liquidity rights or fund portfolio holdings or exposure would not be covered (as under the proposed rules such terms

would have been prohibited in all circumstances, whereas in the final rule they are permitted in some circumstances).

- **Recordkeeping.** In a change from the proposal, the final rules also require advisers who are registered or required to be registered to retain books and records related to the restricted activities rule.

Investment Advisers to Securitized Asset Funds

In a welcome development for sponsors of securitization vehicles or vehicles that issue asset-backed securities such as collateralized loan obligations ("CLOs"), 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. These advisers will not be required to comply with the requirements of the final rules solely with respect to the securitized asset funds that they advise. The final rule defines a securitized asset fund as "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders." While some commenters expressed concern that that final rule definition would not be broad enough to capture CLOs, the Commission confirmed in the adopting release that CLOs are intended to be captured by the securitized asset fund definition. Advisers to securitized asset funds should note that (1) the exemption does not cover their advisory activities with respect to non-securitized asset funds and (2) the requirement in the final rule to document advisers' own annual compliance reviews will still apply (as it applies to all advisers).

Compliance Dates and Legacy Status

The Commission has adopted staggered compliance dates for different portions of the final rules, as set forth below.

Rule	Compliance Period (From the Date of Publication in the Federal Register)
Audit Rule	18 Months
Quarterly Statement Rule	18 Months
Adviser-Led Secondaries Rule	*Advisers with $1.5 billion or more in private funds assets under management ("Larger Private Fund Advisers"):* 12 Months *Advisers with less than $1.5 billion in private funds assets under management ("Smaller Private Fund Advisers"):* 18 Months
Preferential Treatment Rule	*Larger Private Fund Advisers:* 12 Months *Smaller Private Fund Advisers:* 18 Months
Restricted Activities Rule	*Larger Private Fund Advisers:* 12 Months *Smaller Private Fund Advisers:* 18 Months
Advisers Act Compliance Rule	60 Days

The final rules provide "legacy status" to private funds and their governing agreements where such governing agreements were entered into prior to the applicable compliance date if compliance with the applicable rule would otherwise require the parties to amend such an agreement. Legacy status applies only to such agreements with respect to private funds that have commenced operations as of the compliance date (*i.e.,* investment, fundraising, or operational activity). Legacy status does not apply to all of the new rules, but will apply with respect to certain aspects of the restrictions on preferential treatment that prohibit advisers from providing certain preferential redemption rights and information about portfolio holdings. The final rules also provide legacy status for the aspects of the restricted

activities rule that require investor consent, which restrict an adviser from borrowing from a private fund and from charging for certain investigation fees and expenses. However, such legacy status does not permit advisers to charge for 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 or the rules promulgated thereunder.

More Information

This Client Alert is a brief summary of the 660-page final rule release. Chapman will publish further insight and analysis on the final rules in the near future. In addition, as a number of questions and ambiguities have already been raised and identified, advisers should closely monitor guidance from the staff of the Commission compliance dates approach.

If you would like further information concerning the matters discussed in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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