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# NAVIGATING THE SEC'S NEW PRIVATE FUND ADVISER RULES

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PRIVATE & CONFIDENTIAL

# TODAY'S PRESENTERS




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# AGENDA

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- OBSERVATIONS & EXPECTATIONS
- SUMMARY
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    - Preferential Treatment
    - Rules only applicable to Registered Investment Advisers (*RIAs*)
        - Quarterly Statements
        - Annual Audits
        - Adviser-Led Secondaries
        - Written Documentation of Annual Review of Compliance Programs
    - Compliance Dates / "Legacy" Status
    - Questions & Answers

# HOW DID WE GET HERE?

# TIMELINE

- Proposal was released on February 9, 2022.
- Initial comments were due on April 25, 2022.
- Comment period was re-opened twice (in May and October 2022), closing on November 1, 2022.
- The final rules were published in the Federal Register on **September 14, 2023**.



# PROPOSAL REPRESENTED A SIGNIFICANT DEPARTURE FROM REGIME OF INFORMED CONSENT, SOPHISTICATED INVESTORS

- Shift towards a prescriptive regulatory framework similar to the one currently in place for registered investment companies.
- Substitutes the SEC's judgment of what types of conflicts can and cannot be cured by informed consent.

*"Today's proposal represents a sea change. It embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationships with private funds....If we adopt today's proposal, will we choose to redeploy Examinations and Enforcement resources away from their current focus on retail investor protection to the apparently pressing need of protecting millionaire investors from private fund advisers?"*

Commissioner Hester Peirce, Statement on Proposal

# OBSERVATIONS & EXPECTATIONS

# PROHIBITED ACTIVITIES NOT ADOPTED

- Some of the most controversial proposals were not adopted in the final rule:
  1. Seeking reimbursement, indemnification, exculpation or limitation of liability for simple negligence or breach of fiduciary duty.
  2. Waiving, disclaiming or otherwise limiting their fiduciary duties under the Advisers Act or state law.
  3. Charging certain fees and expenses to a portfolio investment in respect of services the adviser does not, or does not reasonably expect to, provide.
- As further noted on the following slide, the SEC's guidance indicated that item (3) above is already generally prohibited by the Advisers Act, and items (1) and (2) may be, depending on the circumstances.

The SEC did not adopt certain of the Proposal's highly contentious "Prohibited Activities" and adopted the remaining items as "Restricted Activities" with disclosure and/or investor consent requirements.

The adopting release noted strong opposition, generally, to flat prohibitions and, specifically, to the items that were not adopted.

# "NEW" GUIDANCE ON FIDUCIARY DUTY

Although the prohibitions on the previous slide were not adopted, the adopting release noted they may be otherwise prohibited under the antifraud provisions of the Advisers Act.

- An adviser cannot waive its *Federal* fiduciary duties.
  - Waivers of fiduciary duty must include a "savings clause" clarifying that the adviser is not waiving its Federal fiduciary duty or that the client retains certain non-waivable rights.
- An adviser may not seek reimbursement, indemnification or exculpation for breach of its fiduciary duty (this would be a prohibited waiver of such duty).
  - Such breach may, depending on the facts and circumstances, include conduct that is intentional, reckless or **negligent**.

The SEC effectively prohibited certain activities through "clarifying" guidance in the adopting release. E.g.:

*…we believe that an adviser may not seek reimbursement, indemnification, or exculpation for breaching its Federal fiduciary duty because such reimbursement, indemnification, or exculpation would operate effectively as a waiver, which would be invalid under the Act.*

Final Release at text accompanying n.783

# KEY TAKEAWAYS

- The Final Rules apply to **private funds** (i.e., funds relying on section 3(c)(1) and 3(c)(7)), which **exclude** securitized asset funds and separately managed accounts.
- The SEC affirmed *Unibanco*.
- The Final Rules apply not just to registered advisers but also to:
    - non-U.S. advisers with respect to U.S. private fund clients
    - **exempt reporting advisers** with respect to **restricted activities** and **preferential treatment**
- Rules have already been challenged by a group of industry trade associations.

# KEY TAKEAWAYS (CONT.)

- Increased regulatory and compliance costs, which may be passed down to investors through increased management fees (and permitted expenses), which may:
    - Make it harder for smaller firms to survive;
    - Result in manager consolidation.
- Offshore advisers may become (1) more competitive and (2) unwilling to have operations or vehicles in the U.S.
- Higher scrutiny of private fund advisers by the SEC during examinations.

# RESTRICTED ACTIVITIES

## *FINAL RULE 211(H)(2)-1*

# RESTRICTED ACTIVITIES WHICH REQUIRE DISCLOSURE ONLY

- An adviser may charge private fund clients for any **regulatory and compliance** fees or expenses so long as the adviser provides written notice to investors of such fees or expenses within 45 days after the end of the fiscal quarter in which such activity occurs.
    - The disclosure must be detailed and include **line-item expenses**.
- An adviser may charge private fund clients certain fees or expenses on a non-pro rata basis provided:
    1. The non-pro rata allocation must be "fair and equitable" under the circumstances; and
    2. The adviser provides prior written notice to investors of the non-pro rata allocation along with an explanation of how it is fair and equitable under the circumstances.

- May apply to tax audits of the GP or adviser. The notice regarding the fees and corresponding dollar amounts would indirectly inform investors of such tax audits.
- The adopting release included examples of fair and equitable reasons to charge non-pro rata fees/expenses:
    - Fees/expenses related to a bespoke fund structuring arrangement.
    - Fees/expenses that have a greater benefit to one fund client than another.
- Non-pro rata allocation rule may apply to allocations of withholding or other tax liabilities—if so, the advance notice requirement could pose practical challenges.

# RESTRICTED ACTIVITIES WHICH REQUIRE DISCLOSURE ONLY (CONT.)

- An adviser may reduce its clawback requirement for actual, potential, or hypothetical taxes so long as the adviser provides written notice to investors of the pre-tax and post-tax amount within 45 days after the end of the fiscal quarter in which such clawback occurs.

- Final Rule is more in line with the industry trend and the notice requirement would not materially deviate from the current market practices.
- The written notice to the investors should include the aggregate dollar amounts of the pre-tax and post-tax clawback obligations. However, it appears that such notice does not necessarily need to include the detailed computation of these amounts.
- Question whether the 45 days window would pose practical challenges.

# RESTRICTED ACTIVITIES WHICH REQUIRE DISCLOSURE AND CONSENT

## Investigation Expenses

- An adviser may charge a private fund for fees and expenses related to an investigation by a governmental or regulatory authority if the adviser:
  1. Gives prior written notice to all investors; and
  2. Obtains prior written consent from a majority of all third-party investors.
- Regardless of whether the adviser provides notice and obtains requisite consent, an adviser **cannot** charge a fund client for investigations that result in a sanction for any Advisers Act violation.

- In the event an adviser has not received a formal notice of an investigation, for determining advanced notice, the adviser would be judged on the information available to determine whether it is "under investigation."
- An adviser cannot obtain a waiver of this prohibition.
- An adviser can obtain consent at the outset of an investigation and charge expenses to a fund, however if the investigation ends with a finding of a violation of the Advisers Act, then the adviser must refund the client.

# RESTRICTED ACTIVITIES WHICH REQUIRE DISCLOSURE AND CONSENT (CONT.)

## Borrowing from Fund Clients by the Adviser

- An adviser may borrow from a fund client if the adviser:

1. Provides written notice of the borrowing with a description of the material terms; and

2. Obtains written consent for the borrowing from a majority of third-party fund investors.

- The notice does not need specific terms, just material terms, e.g., amount borrowed, rate, repayment schedule, etc.

- Express confirmation that tax distributions and management fee offsets are (generally) not borrowings.

- However, certain fund documents require or allow treating a portion of distributions to the general partner in excess of its outside basis as a demand loan to avoid capital gains recognition. Given the consent requirement, this feature should be made optional. In any event, the practicability of such a provision is anticipated to decrease.

# PREFERENTIAL TREATMENT

## *FINAL RULE 211(H)(2)-3*

# PREFERENTIAL LIQUIDITY RIGHTS

- All advisers to private funds are *prohibited* from, directly or indirectly, granting investors a **preferential ability to redeem** interests on terms that the adviser reasonably expects to have a "**material, negative effect**" on other investors, except:
    - if such ability to redeem is required by the applicable laws, rules, regulations or orders of any relevant governmental authority to which the investor, the private fund or any similar pool of assets is subject; or
    - if the adviser offers the same redemption ability to all other existing and future investors, **without qualification**.
- Applies to investors in the private fund or a "similar pool of assets" (substantially similar investment policies, objectives **or** strategies), which includes parallel funds, feeder funds and alternative investment vehicles, as well as certain co-investment vehicles.
- Does not apply to agreements entered into prior to the compliance date *if amendments would be required*.

- "Material, negative effect"
    - Facts and circumstances analysis ("reasonably expects" is judged based on the facts and circumstances at the time of the grant)
    - Evergreen standard
    - More likely if the underlying investments are illiquid
    - Consider each investor's individual circumstances
- "Without qualification" means no commitment size, affiliation or other requirements (such as to invest in another fund or pay higher fees).
    - Multi-class fund structures with different redemption terms and lock-ups are not prohibited if offered to all.
- No exception for more informal arrangements, such as policies and resolutions.
- May apply to special redemption rights to avoid certain adverse tax consequences unique to the investors.

# PREFERENTIAL LIQUIDITY RIGHTS

- Typical liquidity rights which may be affected, depending on their terms:
  - Early withdrawal rights for certain events (e.g., regulatory events due to bad actor disqualification or key person events).
  - Additional withdrawal rights related to 10% voting investor threshold for Section 3(c)(1) funds or 25% ERISA ownership.
  - Exercise by the general partner/adviser of its right to waive notice or other redemption process requirements.
  - Other voluntary withdrawals by the adviser or related person.

# PREFERENTIAL INFORMATION RIGHTS

- All advisers to private funds are *prohibited* from, directly or indirectly, providing **information regarding the portfolio holdings or exposures** to investors if the adviser reasonably expects that providing the information would have a "**material, negative effect**" on other investors, except:
    - if the adviser offers such information to all other existing investors at the same or substantially the same time.
- Information provided in correspondence and oral communications would be subject to this prohibition.
- The same "similar pool of assets" and "legacy" provisions described above with respect to preferential redemption rights apply.

- Focus is on selective disclosure that can result in profits or avoidance of losses (such as submitting an early redemption request at the expense of non-privy investors).
- Ability to redeem is an important part of the determination and the SEC "*would generally not view preferential information rights . . . in an illiquid private fund as having a material, negative effect on other investors*"; however, a material, negative effect is possible even when the preferred investor does not have the ability to redeem.
    - Front-run other investors by taking a short position against an asset, driving down price.
    - Multiple funds with overlapping investments where certain funds have redemption rights.
    - Redemption rights in certain extraordinary circumstances.
- No exception for disclosures required by law or contract.
- May apply to certain tax information rights encompassing details about portfolio holdings or exposures.

# DISCLOSURE OF PREFERENTIAL TREATMENT

- All advisers to private funds are *prohibited* from, directly or indirectly, providing any **preferential treatment** to any investor unless the adviser provides to each prospective investor, **prior to its investment**, specific information regarding any preferential treatment related to any "**material economic terms**" provided to other investors.
- "**Material economic terms**" means "those terms that a prospective investor would find most important and that would significantly impact its bargaining position (i.e., material economic terms, including, but not limited to, the cost of investing, liquidity rights, fee breaks, and **co-investment rights**)."
- Must describe **specifically** the preferential treatment, such as lower fee terms including the applicable rate (or range of rates).

# MATERIAL ECONOMIC TERMS

- Material economic terms *potentially* includes:
  - excuse/exclusion rights
  - limitations of liability (including indemnification)
  - expense caps
  - limitations on the overall investment strategy via side letter
  - co-investment rights (to the extent that they include materially different fee/expense terms)

# POST-CLOSING DISCLOSURE OF PREFERENTIAL TREATMENT

- Advisers are also required to provide to each current investor, disclosure of all preferential treatment provided to other investors:
    - as soon as reasonably practicable following (i) for an illiquid fund, the end of the fundraising period and (ii) for a liquid fund, the investor's investment; and
    - on an annual basis, all preferential treatment provided since the last disclosure.

# POST-CLOSING DISCLOSURE OF PREFERENTIAL TREATMENT

- Comply by providing copies of side letters and similar agreements (with identifying information redacted) or written summaries that specifically describe the preferential treatment.
- The SEC believes that 4 weeks would satisfy the "as soon as reasonably practicable" requirement.
- The SEC is not prescribing the method of delivery (e.g., electronic, data room, mail).
- Annual disclosure requirement includes preferential treatment provided to any transferees in connection with investor transfers.

# NEW REQUIREMENTS FOR RIAS

*FINAL RULES 211(H)(1)-2, 206(4)-10, 211(H)(2)-3, AND 206(4)-7(B)*

# QUARTERLY STATEMENTS (*RULE 211(H)(1)-2*)

- Largely adopted as proposed, but with some modifications:
  - Timing of Quarterly Reports:
    - For non-Fund of Funds: 45-day deadline after quarter end retained for first three quarters but 90-day deadline for fourth quarter end.
    - For Fund of Funds: 75-day deadline after quarter end for first three quarters and 120-day deadline for fourth quarter end.
    - SEC rejected extending deadline to 60 days as it believed "the statements may be too delayed to enable effective engagement and investment decision-making as an investor."
    - Unclear if "fund of funds" is limited to non-affiliated fund of funds (footnote 421 cites to this Custody Rule approach, but there is no definition of fund of funds in the actual Final Rule text).
  - Like the other parts of the Final Rule, securitized asset funds are exempted from the quarterly reporting requirements.
- Books and records amendments would require (among others) that private fund advisers retain copies of any quarterly statement distributed, *as well as* a record of each addressee and the date(s) the statement was sent.

- The SEC generally dismissed or did not specifically address certain issues raised in the SIFMA comment letter, such as the disparity in treatment of reporting requirements for more regulated registered funds.
- Differences between requirements under the Marketing Rule were generally justified by noting the two Rules' different regulatory purposes and the needs of the different types of investors they seek to protect (prospective vs. current investors).
- The SEC believed that increased costs are justified in light of the benefits and that compliance costs may be of "limited magnitude" given that private fund advisers already maintain and disclose similar information to investors.
- The SEC believed annual or semi-annual reporting would be too infrequent and would make it harder for investors to monitor performance.

# QUARTERLY STATEMENTS – FEE AND EXPENSE DISCLOSURE

*Fund-Level Disclosure*

1. A detailed accounting of all compensation, fees and other amounts allocated or paid to the adviser or its related persons by the private fund during the reporting period, with separate line items reflecting categories that include but are not limited to management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation (**adviser compensation**);

2. A detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period (other than those covered above), with separate line items reflecting categories that include but are not limited to organizational, accounting, legal, administration, audit, tax, due diligence and travel fees and expenses (**fund expenses**); and

3. The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods.

*Investment-Level Disclosure*

1. A detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period to both the adviser and its related persons, 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.

- The Final Rule substantially retained the detailed, line-item reporting requirements (aggregation of broad expense types not permitted).

- Final Rule kept requirements that statements:
  - include prominent disclosures explaining calculation methodology and cross references to relevant offering document provisions; and
  - be clear, concise, in plain English and be in a format that facilitates review over subsequent quarters.

- With respect to disclosure of covered portfolio investment compensation, Final Rule still includes related persons (ADV definition) and provides no exceptions for operational independence or where the underlying portfolio investments are not "controlled" by the adviser.

# QUARTERLY STATEMENTS – PERFORMANCE DISCLOSURE

*Liquid Funds*

1. The fund's annual net total returns for each fiscal year over the past 10 fiscal years or since inception (whichever time period is shorter);
2. The fund's annual net total returns over the one-, five- and ten-fiscal year periods (only if and to the extent the fund existed during such periods); and
3. The fund's cumulative net total return for the current fiscal year as of the most recent fiscal quarter covered by the quarterly statement.

*Illiquid Funds*

1. Gross internal rate of return and gross multiple of invested capital;
2. Net internal rate of return and net multiple of invested capital; and
3. Gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.
4. Performance must be computed with and without impact of any fund-level subscription facilities.
5. A statement of contributions and distributions for the illiquid fund.

- The Final Rule defines an "**illiquid fund**" as a private fund that:
    i. is not required to redeem interests upon an investor's request;
    ii. has limited opportunities, if any, for investors to withdraw before termination of the fund.
- A "**liquid fund**" is defined as any private fund that is not an illiquid fund.
- SEC did not provide further carveouts for "hybrid" funds—believed simplified definition of illiquid fund was sufficient.

# ANNUAL AUDITS *(RULE 206(4)-10)*

- Revised to align with the custody rule's "audit exception" (i.e., surprise examinations are no longer an option).
- With respect to a private fund that the adviser does not control (and is not controlled by or under common control with), the adviser must "take all reasonable steps" to cause the fund to prepare and deliver the required audited financial statements.
- Many private fund advisers already do this pursuant to the custody rule under the Advisers Act (Rule 206(4)-2) or pursuant to side letters with institutional investors.

Effectively defers most potential changes until adoption of the Safeguarding Rule changes (e.g., SEC reporting requirement for auditors, treatment of stub periods, etc.)

# ADVISER-LED SECONDARIES (*RULE 211(H)(2)-2*)

- Prior to the close of an adviser-led secondary transaction, RIAs will be required to:
    1. Obtain and provide investors with a fairness opinion *or valuation opinion* from an independent opinion provider; and
    2. Prepare and provide investors with a written summary of any "*material business relationships*" that the adviser, or its related persons, has or had with the independent opinion provider within the two-year period prior to the issuance of the opinion.
- Both must be distributed prior to the due date of any election by investors in the adviser-led secondary transaction.

Applies to transactions initiated by the adviser or any of its related persons that offer the private fund's investors the choice between:

1. selling all or a portion of their interests in the private fund; or
2. converting or exchanging all or a portion of their interest in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

Slight change to the definition was made to exclude most types of tender offers.

Confirmation that "season and sell" transactions and rebalancing transactions would not be covered.

# WRITTEN DOCUMENTATION OF ANNUAL REVIEW OF COMPLIANCE PROGRAMS (*RULE 206(4)-7(B)*)

- Rule 206(4)-7 is amended to require RIAs to document the annual review of their compliance policies and procedures in writing.
- Although written reports for these reviews are quite common, they were not previously specifically required by the rule.
- The SEC reiterated its statements from the proposal that claims of attorney-client privilege and work-product doctrine over required records are inconsistent with an RIA's obligations to produce documents promptly to the SEC and the staff's ability to conduct examinations.

Only aspect of the rule proposal not related to "private funds."

No specific report format is prescribed by the rule.

Guidance on "prompt" delivery under Rule 204-2: electronic records should generally be produced within 24 hours (except in unusual circumstances), but expectation that advisers would be required to furnish records "immediately or within a few hours of request."

# FINAL RULES CONFORMANCE PERIOD FOLLOWING PUBLICATION IN THE FEDERAL REGISTER

| RULE | LARGER PRIVATE FUND ADVISERS COMPLIANCE DATES | SMALLER PRIVATE FUND ADVISERS COMPLIANCE DATES | LEGACY TREATMENT; OTHER NOTES |
|---|---|---|---|
| *Rule 211(h)(1)-2*<br>Quarterly Statement Reporting | 18 months<br>(March 14, 2025) | 18 months<br>(March 14, 2025) | None. |
| *Rule 206(4)-10*<br>Audit Rule Compliance | 18 months<br>(March 14, 2025) | 18 months<br>(March 14, 2025) | None. |
| *Rule 211(h)(2)-1*<br>Restricted Activities | 12 months<br>(September 14, 2024) | 18 months<br>(March 14, 2025) | Legacy treatment only for (a) aspects that require investor consent, e.g., adviser borrowing from a fund (specifically calls out that if borrowing document is already entered into then need not seek investor consent), and (b) charging for certain investigation fees and expense. No need to amend organizational or borrowing documents entered into prior to compliance. |
| *Rule 211(h)(2)-2*<br>Adviser-Led Secondaries | 12 months<br>(September 14, 2024) | 18 months<br>(March 14, 2025) | None. |
| *Rule 211(h)(2)-3*<br>Preferential Treatment | 12 months<br>(September 14, 2024) | 18 months<br>(March 14, 2025) | Legacy treatment only for (a) preferential redemption rights and (b) information rights about portfolio holdings. No need to amend organizational or borrowing documents entered into prior to compliance. |
| *Rule 206(4)-7(b)*<br>Amended Advisers Act Compliance Rule | 60 days<br>(November 13, 2023) | 60 days<br>(November 13, 2023) | Applies to ALL advisers, whether they advise private funds or not.<br>All advisers must document, in writing, their next review commenced within the 12 months following compliance date. |

*Notes regarding transitioning to conformance with the Final Rules:*

"Larger Private Fund Advisers" are classified as advisers with private funds AUM greater than or equal to $1.5 billion.

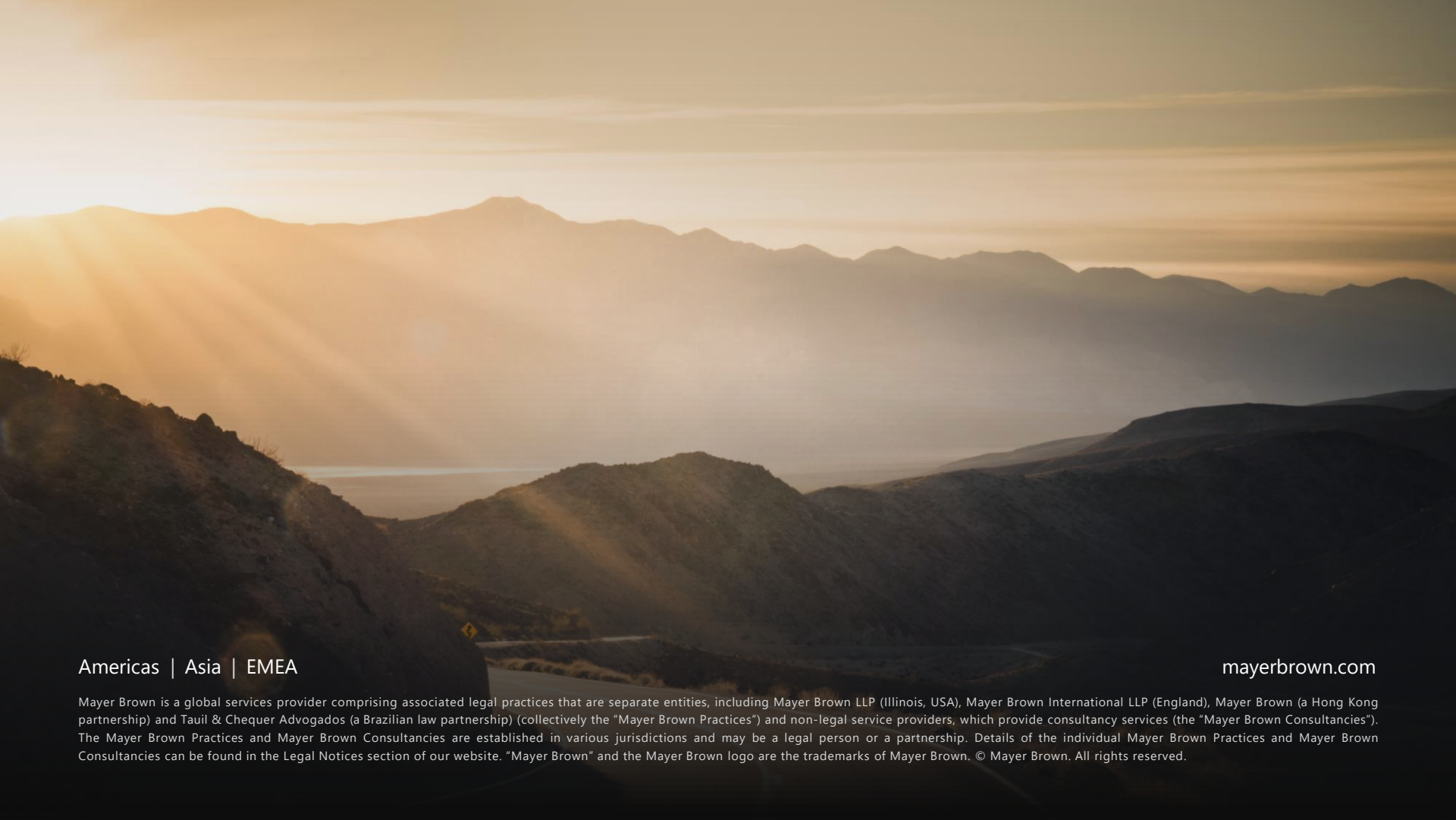
"Smaller Private Fund Advisers" are classified as advisers with private funds AUM of less than $1.5 billion.

"Private funds AUM" is to be calculated as of the last business day of the most recently completed fiscal year, in accordance with Part 1A, Instruction 5.b of Form ADV, for assets under management which are attributable to private funds it advises.

Legacy status ***only*** applies to private funds that commenced operations as of the compliance date.

Advisers ***may not amend*** a side letter to add parties to indirectly obtain legacy treatment. However, admitting new investors to an existing fund (and therefore amending its organizational documents accordingly) ***will not violate***, so long as all terms are set forth in the organizational documents and are applicable to all investors.

# Q&A



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