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Investment Funds & Private Capital Market Insights

SEC Adopts Scaled-Back Version of Private Fund Rules (Part 1 of 2)

4-MINUTE READ

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On August 23, 2023, the SEC voted (3-2) to adopt new rules and amendments under the Investment Advisers Act of 1940 applicable to private fund advisers (*available here*), which were initially proposed in February 2022. For reference, the Paul Hastings Investment Funds & Private Capital (IFPC) client alert on the initial rule proposal is *available here*. The initial proposal represented a significant overhaul to the regulatory regime applicable to private funds and their advisers, and attracted intense industry scrutiny and attention. Accordingly, the final rule release had been hotly anticipated by observers eager to see just how far the agency would go in imposing sweeping new rules.

The final rule release runs to 660 pages, and industry participants will need time to fully digest the contours of the new rules. The following is Part 1 of IFPC's client alerts on the new rules, and includes an overview of certain key considerations. Part 2 will follow with additional detail and analysis on specific provisions.

Why it matters:

- The scaled-back rules have been tempered in both scope and tone from the initial proposal by the SEC.
- Nonetheless, while the new rules and amendments are substantially pared back, (1) the SEC has newly codified into regulation a number of contractual industry standards, and (2) the compliance burdens still will have a significant impact on private fund advisers.

Key Takeaways:

- As had been anticipated, some of the most controversial and impactful provisions have been omitted or modified to include significant exceptions
    - For example, the proposed changes to adviser indemnification and liability standards were not included in the final rule
- Activities that were outright prohibited in the proposal are no longer strictly prohibited, but now include exceptions based on disclosure or investor consent

    - For example, proposed prohibitions are no longer applicable on (A) GP clawback reductions for certain taxes, if the adviser makes certain disclosures to investors regarding the amount of the clawback with and without the effect of the tax reductions and (B) passing through certain regulatory compliance expenses, if the adviser discloses to investors the amount of any such charged expenses on a quarterly basis
    - However, the various disclosure exceptions also are likely to raise interpretive questions
- For GP-led secondary transactions, the final rule requires third-party valuation support, but now includes an option for an adviser to choose between obtaining a fairness opinion or a more limited valuation opinion (that historically has represented a lower-cost alternative to a full-blown fairness opinion process)
- Real-time pre-investment disclosure requirements for side letter provisions are limited to those provisions representing material economic terms (rather than all "preferential" side letter terms)
- At the same time, quarterly statement requirements and side letter disclosure requirements remain largely as proposed, and are likely to raise implementation and interpretive challenges for advisers

Please see below a summary chart comparing certain key provisions of the rule proposal against the final rule. As noted above, this alert will be followed by a subsequent client alert with more robust analysis.

Comparison of Proposal and Final Rule

Miscellaneous	Proposal	Final Rule
Grandfathering (legacy status)	No grandfathering (legacy status) provisions	Limited grandfathering (legacy status) relating to the (a) preferential treatment prohibitions, and (b) restricted activities which require investor consent (*i.e.*, restrictions relating to passing through fees or expenses related to a regulatory or governmental investigation and an adviser borrowing from a fund client)
Compliance period	One year for all advisers for all provisions	Staggered compliance dates: • For quarterly statements and audit rules, 18-month transition period for all private fund advisers • For GP-led secondary transactions, preferential treatment (*i.e.*, side letters) and restricted activities provisions, (a) 12-month transition period for advisers with more than

		$1.5 billion in assets under management and (b) 18-month transition period for advisers with less than $1.5 billion in assets under management • For written annual compliance reviews, compliance required within 60 days of the date published in the Federal Register
Applicability to securitized asset funds (*e.g.*, collateralized loan obligation vehicles)	Applicable to any fund relying on Section 3(c)(1) or Section 3(c)(7), including CLOs	The final rule clarifies that the new private fund adviser rules do ***not*** apply with respect to any securitized asset funds (*e.g.*, CLOs) advised by an adviser; the rule defines "securitized asset fund" as "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders"
Applicability to exempt reporting advisers to private funds	Prohibited activity and preferential treatment provisions would apply not only to RIAs but also to exempt reporting advisers (*e.g.*, venture capital advisers and many non-U.S. advisers that rely on the mid-sized private fund adviser exemption)	Largely unchanged from proposal; exempt reporting advisers will be subject only to restricted activity provisions and preferential treatment provisions

Substantive Requirements	Proposal	Final Rule
Quarterly statements	Provide investors quarterly statements with specified information regarding fund performance, fees and expenses	Largely unchanged from proposal
Annual Audit	(a) Require annual audit for all private funds; and	(a) The annual audit requirement was included in the

	(b) Require auditor to notify the SEC if it issues a modified or qualified opinion or upon resignation or dismissal from the engagement	final rule, but the release clarifies that an annual audit satisfying existing obligations under the Advisers Act custody rule would meet the requirements under the new rule; and (b) The auditor notification requirement is not included in the final rule, but is a component of the proposed amendments to the custody rule (*available here*), and the SEC noted that it is re-opening the comment period on the custody rule proposal
Valuation support in GP-led secondary transactions	For GP-led secondary transactions, require distribution of a fairness opinion and written summary of material business relationships between the opinion provider and the adviser	This requirement is included in the final rule, but advisers would have the option to provide either a fairness opinion or a valuation opinion, which may be a lower cost alternative
Side letter disclosures	Provide advance and annual disclosure to current and prospective investors with respect to any provisions representing "preferential treatment"	Included in final rule, but modified to reduce the pre-investment advance disclosure requirement to apply only to such preferential treatment relating to "any material economic terms" rather than disclosure of all provisions representing "preferential treatment"; other terms can be disclosed, in the case of illiquid funds, as soon as reasonably practicable following the end of the fund's fundraising period
Written annual compliance reviews	Require all registered investment advisers (*i.e.*, not just limited to advisers to private funds) to document their annual compliance review process in writing	Largely unchanged from the proposal

Activity Restrictions	Proposal	Final Rule
Indemnification limitations	Prohibit seeking indemnification / liability limitation / reimbursement for breach of fiduciary duty, willful misfeasance, bad faith, simple negligence or recklessness	Not included in the final rule
Fees for unperformed services	Prohibit advisers from charging fees for unperformed services (*e.g.*, accelerated monitoring fees)	Not included in final rule; SEC commentary notes that a specific prohibition is unnecessary based on its belief that this practice would be inconsistent with an adviser's fiduciary duty under existing interpretations
Charging funds for regulatory, compliance or examination expenses	Prohibit advisers from charging funds for regulatory, compliance or examination expenses	An adviser is not prohibited from this activity, provided the adviser discloses to investors the amount of any such expenses charged to a fund on a quarterly basis
GP clawback reductions	Prohibit advisers from reducing a GP clawback by the amount of certain taxes	An adviser is not prohibited from this activity, provided the adviser provides a written notice to investors that sets forth the clawback amount before and after reduction for actual, potential or hypothetical taxes within 45 days after the end of the quarter in which the clawback occurs
Non-pro rata allocations of fees and expenses for multi-fund investment	Prohibit charging fees or expenses on a non-pro rata basis where multiple funds are invested in the same underlying portfolio investment	An adviser is not prohibited from such allocations, provided the adviser's allocation is fair and equitable and the adviser distributes a written notice to investors describing the non-pro rata allocation and why it is fair and equitable
Charging funds for fees and expenses associated with an investigation by any	Prohibit advisers from passing through fees and expenses related to an investigation by a	An adviser is prohibited from passing through such expenses unless they obtain written

governmental or regulatory authority	governmental or regulatory authority	consent from a majority in interest of fund investors that are not related persons of adviser for charging such fees and expenses; in no event could an adviser pass through expenses related to an investigation that results in a court or governmental authority imposing a sanction for Advisers Act violations
Adviser borrowing from private fund client	Prohibit an adviser from borrowing from its private fund clients	An adviser is prohibited from any such borrowing unless the adviser distributes a written notice, including a description of the material terms of such borrowing, and obtains written consent from a majority in interest of fund investors that are not related persons of adviser
Preferential treatment prohibitions: preferential redemption rights	Prohibit preferential redemption / liquidity rights that the adviser reasonably expects to have a material negative effect on other investors	An adviser is prohibited from offering preferential redemption rights unless (a) the investor is required to obtain such redemption right due to applicable law / governmental requirement, or (b) the adviser has offered such redemption rights to all other existing and future investors
Preferential treatment prohibitions: preferential transparency	Prohibit preferential information / transparency rights	An adviser is prohibited from offering preferential information to an investor unless the adviser offers such information to all other existing and future investors

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Paul Hastings' Investment Funds & Private Capital practice has a truly global footprint, with more than 70 lawyers across the U.S., Europe and Asia. We represent a diverse set of asset managers, private fund sponsors, and institutional investors.

Our Investment Funds & Private Capital – Regulatory practice includes attorneys with deep experience handling sensitive and complex regulatory and compliance issues. In the U.S., we regularly advise on Investment Company Act status and structuring issues, private fund investment manager registration, Investment Advisers Act, Securities Act, Securities Exchange Act and other compliance, SEC examinations and enforcement.

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