ALSTON & BIRD

# Private Fund Advisers Rules and Reforms

## Introduction

On August 23, 2023, the U.S. Securities and Exchange Commission ("SEC") voted 3-2 to adopt new rules and amendments to rules under the Investment Advisers Act of 1940 (the "Advisers Act") affecting registered and unregistered advisers to private funds (the "Final Rules"). In an Adopting Release and Fact Sheet released Wednesday afternoon, the SEC described its decision to adopt these rules, which include significant new requirements for private fund advisers, aimed at protecting the interest of "millions of Americans" who have "indirect exposure to private funds through their participation in public and private pension plans, endowments, foundations, and certain other retirement plans," and at curtailing certain practices, including those arising out of conflicts of interest, that "have the potential to lead to investor harm." While softened from the original proposed rules, the Final Rules contain significant new requirements. In this client alert, we include a summary and discussion of the Final Rules. The Final Rules have staggered effective dates as noted below.

## Restricted Activities Rule (applies to all private fund advisers)

In response to the robust commentary received about the activities the SEC originally proposed to outright prohibit, the SEC generally changed the "prohibited activities" to "restricted activities" in the Final Rules. In an effort to "address certain conflicts of interest that have the potential to lead to investor harm," the Final Rules require that all investment advisers to private funds (registered advisers, unregistered advisers and advisers who are exempt or restricted from registering), either refrain from engaging in certain activities, or disclose such activities to the investors in the private funds they advise, and, in some cases, obtain investor consent. The following discussion in this section addresses each category of restriction.

### *Restricted Activities with Disclosure-Based Exceptions:*

#### Regulatory, Compliance and Examination Expenses

Advisers may not charge a private fund for (i) regulatory or compliance fees and expenses of the adviser or its related persons, or (ii) fees and expenses associated with an examination of the adviser or its related persons by any governmental or regulatory authority, unless the adviser provides written notice of any such fees or expenses, and the dollar amount thereof, to investors in a private fund in writing on at least a quarterly basis. The SEC reiterated that charging these expenses without authority in the governing documents is inconsistent with an adviser's fiduciary duty and noted that advisers may, but are not required to, provide such disclosure in the statements they must deliver to investors under the quarterly statement rule if they are subject to that rule.

#### Reducing Adviser Clawbacks for Taxes

Advisers may not reduce the amount of a performance-based compensation clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders, unless the adviser discloses the pre-tax and post-tax amount of the clawback to investors. The SEC noted that this proposal received robust commentary and moved away from the outright prohibition where advisers "satisfy certain disclosure requirements designed to better inform private fund investors of the impact of after-tax adviser clawback reductions." We have not seen any

official guidance prohibiting the use of an "American-style," or requiring the use of a "European-style," distribution waterfall.

**Certain Non-Pro Rata Fee and Expense Allocations**

Advisers may not directly or indirectly charge or allocate fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment, unless (i) the non-pro rata charge or allocation is fair and equitable under the circumstances and (ii) 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.

***Restricted Activities with Investor Consent Exceptions:***

**Borrowing**

Advisers may not directly or indirectly borrow money, securities, or other fund assets, or receive a loan or an extension of credit, from a private fund client without disclosing to, and obtaining consent from, such fund's investors. The Final Rules do not list the specific terms of a borrowing that must be disclosed in connection with an adviser's consent request; rather, it requires advisers to disclose the prospective borrowing and the material terms related thereto. The Adopting Release explains that this could include the amount of money to be borrowed, the interest rate, and the repayment schedule, depending on the facts and circumstances.

**Investigation Expenses**

Advisers may not charge their private fund clients for fees and expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, unless the adviser seeks consent from all investors of the 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.

The SEC was careful to distinguish that the exception does <u>not</u> apply to fees or expenses related to an investigation that results in a court or governmental authority imposing a sanction for a violation of the Advisers Act or related rules, which would be prohibited.

In general, instead of outright prohibitions, here we see the SEC responding to commenters by permitting certain activities to continue but imposing significant disclosure and even consent requirements to accompany such activities.

***No New Rules on "Certain Adviser Misconduct"***

Notably, the SEC declined to adopt the proposed rules that would have prohibited what they called "Certain Adviser Misconduct" in the Adopting Release. Specifically:

(1) The SEC declined to prohibit advisers from charging a portfolio investment for monitoring, servicing, consulting, or other fees with respect to any services the investment adviser does not, or does not

reasonably expect to, provide to the portfolio investment. The SEC's focus here would have been on accelerated payments under services agreements an adviser may enter into at the portfolio company-level (*e.g.*, monitoring and management services agreements). The SEC noted, however, that it found it "unnecessary for the final rule to prohibit an adviser from charging fees without providing a corresponding service to its private fund client because such activity already is inconsistent with the adviser's fiduciary duty."

(2) Similarly, the SEC declined to prohibit advisers from seeking indemnification, reimbursement, exculpation or limitation of liability for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund, but reiterated that advisers' fiduciary obligations to their clients remain unchanged.

**Preferential Treatment Rule (applies to all private fund advisers)**

***Private fund advisers will be prohibited from providing preferential treatment to certain investors in private funds managed or advised by the adviser, including preferential terms regarding redemption or information about portfolio holdings or exposures, unless disclosed to existing and prospective investors.***

The Final Rules prohibit all private fund advisers, regardless of whether they are registered with the SEC, from granting an investor in a private fund or in a similar pool of assets managed or advised by the adviser (i.e., any private fund client), the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a similar pool of assets[1]. This prohibition also includes indirect preferential treatment by the adviser through its related persons. Preferential terms are provided through side letters or otherwise. Preferential treatment is prohibited unless the adviser provides written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons are providing to other investors in the same fund. Similarly, preferential information rights about portfolio holdings or exposures are prohibited, unless the adviser offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time. There are otherwise no exemptions to the rule.

The requirement of advance written notice to prospective investors applies only to material economic terms (as opposed to all investment terms). Advisers are required to provide current investors with comprehensive, disclosure of all preferential treatment provided by the adviser or its related persons since the last notice, both annually and as soon as reasonably practicable after certain conditions.

The timing requirements for delivery of notice are as follows:

- Comprehensive notice: For existing investors, the adviser must distribute a notice describing preferential treatment if preferential treatment has been provided to an investor since the last notice.
- Material economic terms only: For prospective investors, the adviser must provide notice, in writing, prior to the investor's investment.

[1] The Final Rules define the term as a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser or its related persons.

There are two exceptions to the preferential redemptions rights rule:

- Redemptions that are required by applicable law, rule, regulation, or order of certain governmental authorities.
- If the adviser has offered the same redemption ability to all existing investors and will continue to offer the same redemption ability to all future investors in the private fund or similar pool of assets

Written notice of all preferential treatment the adviser or its related persons have provided to other investors in the same private fund must be delivered as follows:

- For an illiquid fund[2], as soon as reasonably practicable following the end of the fund's fundraising period.
- For a liquid fund,[3] as soon as reasonably practicable following the investor's investment in the private fund.

**Quarterly Statement Rule (applies to registered investment advisers ("RIAs" to private funds)**

***Quarterly Statements***

Registered investment advisers must prepare and distribute a quarterly statement that includes information regarding fees, expenses, and performance for any private fund they advise. If the private fund is not a fund of funds, then a quarterly statement must be distributed within 45 days after the end of each of the first three fiscal quarters of each fiscal year and 90 days after the end of each fiscal year. If the private fund is a fund of funds, then a quarterly statement must be distributed within 75 days after the first, second, and third fiscal quarter ends and 120 days after the end of the fiscal year of the private fund. As noted, private fund advisers with less than $150 million in assets under management or those with less than $100 million in regulatory assets under management will not be subject to the quarterly statements rule.

Information required in the periodic statements is as follows:

**Fees and expenses:** In an organized, tabular format, advisers must disclose:

- Adviser compensation: A detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the private fund during the quarterly reporting period. Compensation disclosures cover all management, advisory, and sub-advisory fees, and performance-based compensation. The same accounting must be provided for payments or allocations made to the adviser's "related persons."[4]

[2] The Final Rules define "illiquid fund" as a private fund that: (i) is not required to redeem interests upon an investor's request and (ii) has limited opportunities, if any, for investors to withdraw before termination of the fund.

[3] The Final Rules define "liquid fund" as any private fund that is not an illiquid fund.

[4] The Final Rules define "related persons" as (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser. "Person" would include entities such as general partner affiliates.

- Fund fees and expenses: A detailed accounting of all fees and expenses paid by or allocated to the private fund during the quarterly reporting period.
- Offsets and rebates: Disclosure of any offsets or rebates carried forward during the quarterly reporting period to subsequent reporting periods to reduce future payments or allocations to the adviser or its related persons. The adviser must present the dollar amount of each category of adviser compensation or fund expense before and after any such reductions for the quarterly reporting period.

**Portfolio investment-level disclosure**: In an organized, tabular format, advisers must disclose the following:

- A detailed accounting of all portfolio investment[5] compensation allocated or paid by each covered portfolio during the quarterly reporting period.
- Separate line items must be included for each category of allocation of payment reflecting total dollar amount, including origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments by the portfolio investment to the adviser or any of its related persons.
- The identity of each portfolio investment should be disclosed for conflicts purposes.
- The table must list the private fund's ownership percentage of each portfolio investment that paid or allocated compensation to the adviser or its related persons during the reporting period.

**Calculations and cross-references to organizational and offering documents**: Advisers must provide prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers and offsets are calculated. Advisers must also provide cross-references to the relevant sections of the private fund's organizational and offering documents that set forth the calculation methodology. Methodology must include criteria on which each type of compensation is based.

**Performance disclosure:** Advisers must disclose standardized fund performance information in each quarterly statement, including displaying the different categories of required performance information with equal prominence. The rule proscribes different disclosure approaches for liquid and illiquid funds. The SEC mandates that performance be calculated excluding fund-level subscription facilities (as defined in the rule), stating that these artificially inflate performance metrics. Additionally, advisers must prominently disclose the criteria used and assumptions made in calculating performance information. Advisers must retain books and records related to the quarterly statement rule.

- Advisers to liquid funds must disclose performance information
  - (i) based on net total return on an annual basis for the 10 fiscal years prior to the quarterly statement or since the fund's inception (whichever is shorter), over one-, five-, and 10-fiscal year periods, and-
  - (ii) on a cumulative basis for the current fiscal year as of the end of the most recent fiscal quarter.

[5] The Final Rules define "covered portfolio investments" as portfolio investments that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period.

- Advisers to illiquid funds must disclose the following performance measures in each quarterly statement, shown since inception of the illiquid fund and computed with and without the impact of any fund-level subscription facilities
    - (i) gross internal rate of return[6] and gross multiple of invested capital[7] for the illiquid fund,
    - (ii) net internal rate of return and net multiple of invested capital for the illiquid fund, and-
    - (ii) 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

**Private Fund Audit Rule (applies to RIAs to private funds)**

***Annual Audits of Private Funds***

Consistent with the requirements of the audit provision in Rule 206(4)- under the Advisers Act (the "Custody Rule"), registered investment advisers will be required to obtain an annual financial statement audit of the private funds they advise, directly or indirectly. The SEC noted that the financial statement audits must meet the requirements of the audit provision in the Custody Rule as it currently exists – not the 'Safeguarding Rule' as originally proposed. The mandatory private fund adviser audit must meet the requirements set forth in paragraphs (b)(4)(i) through (b)(4)(iii) of the Custody Rule applicable to pooled investment vehicles subject to annual audit and cause audited financial statements to be delivered in accordance with paragraph (c) of that rule. For non-controlling advisers, such as sub-advisers unaffiliated with a private fund, the Final Rules do not require that the non-control adviser take reasonable steps to cause its private fund client to undergo an audit *if* the fund is already undergoing an audit. Advisers must keep a copy of any audited financial statements, along with a record of each addressee and the corresponding date(s) sent.

Under the Final Rules:

(i) The audit must be performed by an independent public accountant that meets the standards of independence,[8] and that is registered with and is subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board (PCAOB).

(ii) The audit must meet the definition of audit[9], the professional engagement period of which shall begin and end as indicated in Regulation S-X rule 2-01(f)(5).

(iii) Audited financial statements must be prepared in accordance with U.S. GAAP.

---

[6] The Final Rules define "internal rate of return" as the discount rate that causes the net present value of all cash flows throughout the life of the private fund to be equal to zero.

[7] The Final Rules define "multiple of invested capital" as (i) the sum of: (A) the unrealized value of the illiquid fund; and (B) the value of all distributions made by the illiquid fund; (ii) divided by the total capital contributed to the illiquid fund by its investors.

[8] 17 CFR 210.2-01(b) and (c) (in rule 2-01(b) and (c) of Regulation S-X)

[9] 17 CFR 210.1-02(d) (rule 1-02(d) of Regulation S-X)

(iv) Annually within 120 days of the private fund's fiscal year end and promptly upon liquidation, the private fund's audited financial statements are to be distributed – this distribution would consist of the applicable financial statements, related schedules, accompanying footnotes, and the audit report.

**Adviser-Led Secondaries Rule (applies to RIAs to private funds)**

***RIAs to private funds must obtain a fairness opinion or valuation opinion in connection with an adviser-led secondary transaction.***

Registered investment advisers to private funds now must obtain either a fairness opinion or a valuation opinion in connection with any adviser-led secondary when offering existing fund investors the option between selling their interests in a private fund and converting or exchanging their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. The adviser must distribute to the fund's investors:

(1) such written opinion, and

(2) a written summary of any material business relationships the independent opinion provider has or has had within the past two years with the adviser or any of its related persons.

The SEC's decision represents minor flexibility in response to comments received on the topic with the addition of a valuation opinion as an acceptable option (whereas the proposed rule required a fairness opinion).

**Amendments to the Compliance Rule (applies to all RIAs, even those that do not manage private funds)**

***All RIAs must annually document a review of their compliance policies and procedures in writing.***

Without departing from its proposal, the SEC adopted amendments to Rule 206(4)-7 (the "Compliance Rule") and Rule 204-2 (the "Books and Records Rule") under the Advisers Act to require all RIAs, on a "no less frequently than" annual basis, to document their compliance policies and procedures reviews in writing and to retain those records pursuant to the Books and Records Rule. The Fact Sheet released in connection with the Final Rules explained that the new documentation requirement is intended to "help the Commission to determine advisers' compliance with the rules and identify potential compliance program weaknesses."

In terms of content, the Adopting Release stated "the annual review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies and procedures." Beyond that, the Compliance Rule does not enumerate specific elements that advisers must include in the written documentation of their annual review. In the past, the SEC has explained that the annual review should assess the regulatory and compliance risks present in the adviser's business that may result in violations of the Advisers Act and determine procedures and processes needed to manage or mitigate these risks, meaning that the actual content of such written reviews may vary among advisers based on the types of funds they manage.

As a practical matter, RIAs have been conducting annual reviews pursuant to the Compliance Rule but will now need to document their annual review in a written record, kept pursuant to the requirements of the

Books and Records Rule. RIAs need to be mindful that such records are sufficiently detailed and easily retrieved. RIAs should examine their current recordkeeping processes and determine whether an update is required.

**Legacy Status**

In response to comments, the SEC provided legacy status for the prohibitions portion of the Preferential Treatment Rule and the portions of the Restricted Activities Rule that require investor consent. The legacy status will only apply to governing agreements that were entered into prior to the compliance date if the applicable rule would require the parties to amend those agreements. "To prevent advisers from abusing this provision," the SEC explained that the legacy status will only apply to such agreements with respect to private funds that had commenced operations[10] as of the compliance date.

**Staggered Compliance Dates**

The Final Rules are effective 60 days after their publication in the Federal Register. The SEC has provided transition periods in some cases with compliance dates for the Final Rules as follows:

| Rule: | Timeline |
|---|---|
| Private Fund Audit Rule and Quarterly Statement Rule | 18 months after the date of publication in the Federal Register |
| Adviser-Led Secondaries Rule, Preferential Treatment Rule, and Restricted Activities Rule | 1. For advisers with $1.5 billion or more in private funds assets under management, 12 months after the date of publication in the Federal Register<br>2. For advisers with less than $1.5 billion in private funds assets under management, 18 months after the date of publication in the Federal Register |
| Amendments to the Compliance Rule | 60 days after publication in the Federal Register |

**Conclusions and Practical Considerations**

While the SEC showed some receptiveness to industry comments by shifting towards more disclosure-based requirements, the SEC nonetheless moved forward with a significant number of new restrictions on private fund advisers. Advisers should assess their existing policies with their legal advisers to assess where updates will be required and pay particular attention to funds that may be in the process of formation but have not yet been launched when drafting definitive agreements and communicating with potential investors. The team at Alston & Bird has stayed abreast of the Private Fund Adviser Reforms and would be happy to discuss individualized plans for fund managers seeking to ensure their compliance with these new rules.

[10] Examples of activity that could indicate a private fund has commenced operations include issuing capital calls, setting up a subscription facility for the fund, holding an initial fund closing and conducting due diligence on potential fund investments, or making an investment on behalf of the fund.

## Investment Funds Team


Kitan O. Ajanaku
404.881.7409
kitan.ajanaku@alston.com

Mustafa Almusawi
202.239.3176
mustafa.almusawi@alston.com

David J. Baum
202.239.3346
david.baum@alston.com

Amie Benedetto
404.881.4830
amie.benedetto@alston.com

Juan Bernal
404.881.7828
juan.bernal@alston.com

Waylon Bryson
919.862.2256
waylon.bryson@alston.com

Joseph Burby
404.881.7670
joey.burby@alston.com

Andrew Burton
404.881.7362
andrew.burton@alston.com

Lauren Burton
+44.20.8161.4372
lauren.burton@alston.com

George J. Cahill
212.210.9412
george.cahill@alston.com

Katherine Carter
704.444.1279
katherine.carter@alston.com

Austin Charles
404.881.7883
austin.charles@alston.com

Siena Cornacchini
212.210.9487
siena.cornacchini@alston.com

Martin H. Dozier
404.881.4932
martin.dozier@alston.com

Blake E. Estes
212.210.9415
blake.estes@alston.com

Timothy J. Fitzmaurice
404.881.4640
tim.fitzmaurice@alston.com

David C. Fratto
404.881.7832
david.fratto@alston.com

Brian D. Frey
202.239.3067
brian.frey@alston.com

Mathew Gray
212.210.9410
mathew.gray@alston.com

Katherine Doty Hanniford
202.239.3725
kate.hanniford@alston.com

Jeff Hill
212.210.9430
jeff.hill@alston.com

Kristin P. Hinson
704.444.1332
kris.hinson@alston.com

Colby B. Jenkins
704.444.1280
colby.jenkins@alston.com

Saloni Joshi
+44.20.2161.4377
saloni.joshi@alston.com

MaryKate Kustas
212.210.9514
marykate.kustas@alston.com

Channing Lansdell
404.881.7862
channing.lansdell@alston.com

Megan Lau
+44.20.8161.4349
megan.lau@alston.com

Branson Lee
404.881.4773
branson.lee@alston.com

Clay A. Littlefield
704.444.1440
212.210.9570
clay.littlefield@alston.com

Dustin J. Littrell
214.922.3475
dustin.littrell@alston.com

Paul N. Monnin
404.881.7394
paul.monnin@alston.com

Carlin O'Donnell
212.210.9469
carlin.odonnell@alston.com

BJay Pak
404.881.7816
bjay.pak@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

MacRae Robinson
704.444.1166
macrae.robinson@alston.com

Jody Rosen
202.239.3472
jody.rosen@alston.com

Mayuri Roy-Altenkirch
+44.20.8161.4380
mayuri.roy-altenkirch@alston.com

Gina M. Russoniello
704.444.1451
gina.russoniello@alston.com

Timothy P. Selby
212.210.9494
tim.selby@alston.com

Albert B. Stieglitz, Jr.
202.239.3168
albert.stieglitz@alston.com