SEC Adopts Significant New Requirements for Advisers to Private Funds

On August 23, 2023, the Securities and Exchange Commission (SEC) adopted final regulations in a 658-page Adopting Release, significantly increasing the regulatory burden on advisers to private funds (the "Final Rule").[1]

Among other things, the Final Rule will significantly impact the scope and timing of private fund financial reporting, prohibit certain fund terms and activities that the SEC deems contrary to investors' interests, and mandate new disclosures of preferential investor rights. As discussed below, the new rules impact both private fund advisers that are registered ("Registered Private Fund Advisers") under the Investment Adviser's Act of 1940 (the "Advisers Act") and (in some cases) also private fund advisers that are exempt from registration (such exempt private fund advisers, together with Registered Fund Advisers, the "Private Fund Advisers").[2]

The Final Rule was adopted by a 3 to 2 vote of the SEC Commissioners (breaking along party lines) after the SEC received many comments on the initially proposed rule arguing that the SEC was overreaching its authority. The primary components of the Final Rule are outlined below. We note, however, that the SEC did not adopt its most controversial proposal - the prohibition on Private Fund Advisers seeking reimbursement, indemnification, exculpation, or limiting its liability or the liability of other covered persons for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund. Instead, in the Adopting Release, the SEC reaffirmed and clarified its position that Private Fund Advisers' existing federal fiduciary duty and obligations under the Advisers Act, including the antifraud provisions thereof, deter and remedy the "problematic practice"[3] of advisers seeking reimbursement, indemnification, or exculpation "effectively as a waiver"[4] of fiduciary duties.

Final Rule Requirements Impacting Registered Private Fund Advisers

Quarterly Statement Rule. Within 45 days after each fiscal quarter end and 90 days after the fiscal year end of a private fund (or 75 days after each fiscal quarter end and 120 days after the fiscal year end, for a private fund that is a fund of funds), a Registered Private Fund Adviser must distribute the information outlined below to the investors of each private fund it advises.[5] This quarterly reporting is required to be

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1 Private funds refers to investment funds that rely on the exemption from registration in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), including most private equity, venture capital, and other closed-end investment funds.

2 In the Adopting Release, the SEC confirmed that, other than the Compliance Rule Amendment, the Final Rule will not apply to Private Fund Advisers that have their principal office and place of business outside the U.S. with respect to their funds organized outside the U.S., regardless of whether such funds have U.S. investors.

3 Adopting Release, at Page 256.

4 Adopting Release, at Page 260.

5 Private Fund Advisers are not subject to the following rules with respect to securitized asset funds they advise: the Quarterly Statement Rule, the Private Fund Audit Rule, the Adviser-Led Secondaries Rule, the Restricted Activities Rule and the Preferential Treatment Rule.

consolidated with information for "similar pools of assets"[6] to the extent that would be meaningful to investors, and to be presented in clear, concise, plain English and in a format that facilitates review from one quarterly statement to the next.

The quarterly reports must include:

(a) A "Fund Table" that discloses, for each quarterly period:

1. all fees and other compensation paid to the Registered Private Fund Adviser or any of its "related persons"[7] during such quarter by the private fund, with separate line-item categories, including, management fees and performance-based compensation;

2. all other fees and expenses allocated to or paid by the private fund during such quarter, with separate line-item categories, including organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and

3. the amount of any management fee or similar offsets or rebates carried forward during such quarter.

(b) A "Portfolio Investment Table" that discloses, for each "covered portfolio investment,"[8] all portfolio investment compensation (*e.g.*, origination, management, consulting, monitoring, or directors fees, etc.) allocated or paid to the Registered Private Fund Adviser or any of its related persons by the covered portfolio investment during such quarter, with separate line items for each category of allocation or payment, presented both before and after the application of any offsets, rebates, or waivers.

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[6] A "similar pool of assets" means an investment vehicle (other than an investment company registered under the Investment Company Act, or a securitized asset fund) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the investment adviser or its related persons (as defined in footnote 7, below). Similar pools of assets would include parallel funds and potentially other co-investment vehicles of a private fund.

[7] "Related persons" include the adviser's officers, partners, directors, employees, and affiliates.

[8] A "covered portfolio investment" is any portfolio investment that paid portfolio investment compensation in the applicable reporting period.

For Illiquid Funds, the following performance information as of a specified date: [9]

1. Gross "IRR"[10] and gross "MOIC"[11] for the fund;

2. Net IRR and net MOIC for the fund;

3. Gross IRR and gross MOIC for the realized and unrealized portions of the fund's portfolio, with the realized and unrealized performance shown separately; and

4. A statement of contributions to and distributions from the fund.

For Illiquid Funds, performance measures must be shown from inception of the fund through the end of the applicable quarter and must be computed with and without the impact of any fund-level subscription facilities (including the impact of any interest payments and other expenses of any such facility).

The quarterly performance statement must include the date through which the performance information is current.

Each quarterly statement must also include "prominent disclosure" regarding (a) the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated, including cross references to the relevant sections of the private fund's organizational and offering documents, and (b) criteria used and assumptions made in calculating private fund performance.

The compliance date for the Quarterly Statement Rule will be 18 months after the date of publication of the Final Rule in the Federal Register (the "Publication Date").

Private Fund Audit Rule. Registered Private Fund Advisers are required to provide private fund investors with annual financial statements for each private fund they manage, audited by an independent public accountant registered with the PCAOB. The audited financial statements are required to be consistent with the audit provisions of the current SEC Custody Rule. This will effectively eliminate the surprise examination alternative to the audit requirement under the Custody Rule for Registered Private Fund Advisers. For any private fund client that a Registered Private Fund Adviser does not control (e.g., a sub-advisory non-affiliated, private fund client), a Registered Private Fund Adviser will be required to take all

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[9] These requirements are for "Illiquid Funds," defined 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. "Liquid Funds" (which are any private funds other than Illiquid Funds) must instead report total net returns for the fiscal year to date, average net returns for one-, five- and 10- fiscal year periods and annual total net returns for each fiscal year over the past 10 fiscal years or since inception, whichever time-period is shorter.

[10] "Internal Rate of Return" (IRR) means the discount rate that causes the net present value of all cash flows throughout the life of the fund to be equal to zero. "Gross Internal Rate of Return" (Gross IRR) is calculated gross of all fees and expenses including Performance-Based Compensation borne by the private fund, and "Net Internal Rate of Return" (Net IRR) is calculated net of all such items. "Performance-Based Compensation" means allocations, payments, or distributions of capital based on the private fund's (or any of its investments') capital gains, capital appreciation and/or other profit.

[11] "Multiple on Invested Capital" (MOIC) means as of the end of the applicable fiscal quarter, the sum of (x) the unrealized value of the fund; and (y) the value of all distributions made by the private fund; divided by the total capital contributed to the fund by its investors. "Gross Multiple on Invested Capital" (Gross MOIC) is calculated gross of all fees and expenses including Performance-Based Compensation borne by the private fund, and "Net Multiple on Invested Capital" (Net MOIC) is calculated net of all such items.

reasonable steps to ensure that such private fund client undertakes an audit in compliance with the Private Fund Audit Rule, if such client does not otherwise undergo such an audit and to keep records of the steps taken. The compliance date for the Private Fund Audit Rule will be 18 months after the Publication Date.

Adviser-Led Secondaries Rule. In connection with any transaction where a Registered Private Fund Adviser offers fund investors the option between selling all or a portion of their interests in a private fund and converting or exchanging such interests for a new interest in another vehicle advised by the adviser or its related persons (*e.g.*, a "continuation fund," "extension fund," "stapled commitment" or rollover transaction or similar adviser-led secondary transaction), the Registered Private Fund Adviser must obtain and distribute to fund investors a fairness opinion or valuation opinion on the transaction price from an independent opinion provider (and disclose any material business relationship between the opinion provider and the Registered Private Fund Adviser, or its related persons within the two-year period prior to the issuance of such opinion). This rule addresses the conflicts of interest regarding valuation of interests and an adviser's compensation in connection with adviser-led secondary transactions, where the adviser sits on both sides of a transaction.

Registered Private Fund Advisers with $1.5 billion or more in private fund assets under management must be in compliance with the Adviser-Led Secondaries Rule 12 months after the Publication Date, and Registered Private Fund Advisers with less than $1.5 billion in private fund assets under management must be in compliance with the Adviser-Led Secondaries Rule 18 months after the Publication Date.

The Compliance Rule and the Books and Records Rule Amendments to Advisers Act. All registered investment advisers, including Registered Private Fund Advisers, must document in writing, at least annually, the adequacy of their compliance policies and procedures, and the effectiveness of their implementation thereof, though the Final Rule does not enumerate specific elements that must be included in the written documentation of the annual review. The SEC has stated that this documentation requirement is intended to be flexible. Compliance with the Compliance Rule Amendment will be required 60 days after the Publication Date.

In addition, Registered Private Fund Advisers are required to retain books and records related to the Quarterly Statement Rule, the Private Fund Audit Rule, the Adviser-Led Secondaries Rule, and the Preferential Treatment Rule.

Final Rule Impacting All Private Fund Advisers

Restricted Activities Rule. The Final Rule restricts all Private Fund Advisers from:

(a) Charging or allocating to the private fund fees or expenses associated with an investigation of the adviser or its related persons without disclosure and consent from fund investors; *provided* that an adviser may not charge 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 (the "Sanctions Exception"); [12]

[12] The Private Fund Adviser must request the prior consent from each investor of the private fund and must obtain the consent of at least a majority in interest of the private fund's investors that are not related persons. This consent requirement may not be satisfied by consent or approval of any investor advisory committee or "LPAC" and establishes that prior blanket consents, in the private fund governing documents or otherwise, will not be sufficient to comply with the requirement.

(b) Charging or allocating to the private fund regulatory, examination, or compliance fees or expenses of the adviser or its related persons, unless such fees and expenses are disclosed to each of the fund's investors in writing within 45 days after the end of the fiscal quarter in which the charge or allocation occurs;

(c) Reducing the amount of an adviser carried interest or similar clawback by the amount of certain taxes applicable to the adviser or its related persons (whether actual, potential or hypothetical), unless the adviser discloses the pre-tax and post-tax amount of the clawback to each of the fund's investors in writing within 45 days after the end of the fiscal quarter in which the adviser clawback occurs;

(d) Charging or allocating fees or expenses related to an actual or potential portfolio investment on a non-pro rata basis across multiple private funds and other clients participate (or proposed to participate), unless the allocation approach is fair and equitable and the adviser distributes, in advance of such charge or allocation, written notice of the non-pro rata charge and a description of how the allocation approach is fair and equitable under the circumstances; and

(e) Borrowing or receiving a loan or an extension of credit from a private fund client without disclosure of the material terms thereof to, and consent from, fund investors. [13]

Private Fund Advisers with $1.5 billion or more in private fund assets under management must be in compliance with the Restricted Activities Rule 12 months after the Publication Date, and Private Fund Advisers with less than $1.5 billion in private fund assets under management must be in compliance with the Restricted Activities Rule 18 months after the Publication Date.

The SEC has further provided legacy status (*i.e.*, grandfathering) for investor consents regarding investigations (clause (a) above) and borrowing (clause (e) above). Legacy status will apply to contractual agreements governing a private fund (and, with respect to clause (e), contractual agreements governing a borrowing, loan, or extension of credit entered into by a private fund) where the private fund has commenced operations as of the compliance date, and in each case, as applicable, compliance would require the parties to amend the applicable agreements; *provided* that this legacy status does not apply to the Sanctions Exception.

Preferential Treatment Rule. The Final Rule restricts all Private Fund Advisers, directly or indirectly, from providing preferential terms to any investors in a private fund (including any similar pools of assets[14]) that the adviser reasonably expects to have a material, negative effect on the other investors in that private fund (or any similar pool of assets) regarding:

(a) Certain redemptions from the private fund, unless the ability to redeem is required by applicable law[15] or the adviser offers (and will continue to offer) the preferential redemption rights to all other

[13] See disclosure and consent requirements at footnote 12, above.

[14] See footnote 6 for the definition of "similar pools of assets."

[15] Redemption rights pursuant to applicable law would still have to be disclosed to all investors, as discussed below. The SEC also notes that the "applicable law" carve-out does not extend to redemption rights granted in accordance with more informal arrangements, such as an investor's policies or resolutions. See Adopting Release, at pages 277-278.

investors in the private fund (including any similar pools of assets) without qualification (*e.g.*, no commitment size, affiliate requirements, or other limitations); [16] and

(b) Certain preferential information about portfolio holdings or exposures, unless such preferential information is offered to all investors of the private fund (including any similar pools of assets) at the same time or substantially the same time.

In addition, the Preferential Treatment Rule prohibits all Private Fund Advisers, directly or indirectly, from providing preferential treatment to investors in a private fund (including any similar pools of assets), unless they provide the following notices and/or disclosures as applicable:

1. With respect to a prospective investor in a private fund, a written notice that provides specific information regarding any preferential treatment related to any material economic terms that the adviser or its related persons have provided to other investors in the same private fund; and

2. With respect to current investors in an Illiquid Fund, as soon as reasonably practicable following the end of the Illiquid Fund's fundraising period (*i.e.*, the final closing date as set forth in the private fund governing documents), written disclosure of all preferential treatment (not merely preferential treatment related to any material economic terms) the adviser or its related persons has provided to other investors in the same private fund.[17]

In addition, on at least an annual basis, each Private Fund Adviser must deliver to investors in its private funds a written notice that provides specific information regarding any preferential treatment provided by the Private Fund Adviser or its related persons to other investors in the same private funds since the last written notice.

These notice and disclosure requirements may require Private Fund Advisers to distribute all side letter provisions, without the ability to hold back certain provisions as typically provided in customary "most favored nation" provisions.[18]

Private Fund Advisers with $1.5 billion or more in private fund assets under management must be in compliance with the Preferential Treatment Rule 12 months after the Publication Date, and Private Fund Advisers with less than $1.5 billion in private fund assets under management must be in compliance with the Preferential Treatment Rule 18 months after the Publication Date.

The SEC has also provided legacy status for the redemption provision (clause (a) above) and the portfolio holding disclosures (clause (b) above). Legacy status will apply to contractual agreements governing a private fund where the private fund has commenced operations as of the compliance date, and in each case, as applicable, compliance would require the parties to amend the applicable agreements.

[16] See Adopting Release, at page 279.

[17] For Liquid Funds, the adviser must distribute the required notice as soon as reasonably practicable following the investor's investment in the private fund.

[18] See SEC general discussion of MFN processes, at Adopting Release, at pages 292-293.

What's Next?

Going forward, Private Fund Advisers should continue to monitor further developing SEC regulatory changes, review internal policies and procedures to ensure compliance with existing SEC rules, and take steps to ensure consistency between actual fund operations, and fund governing and offering documents.

Choate's team is continuing to monitor developments related to the Final Rule and will issue further client alerts on specific requirements set forth in the Final Rule in the weeks and months to come. Please do not hesitate to contact us with any questions.

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