SEC Makes Sweeping Changes to Private Fund Adviser Regulatory Regime: Mandates Quarterly Reporting, Restricts Preferential Treatment and Side Letters

AUGUST 28, 2023

In a 3-2 vote on August 23, 2023, the Securities and Exchange Commission ("SEC" or "Commission") adopted five new rules under the Investment Advisers Act of 1940 (the "Advisers Act"), collectively called the "Private Fund Adviser Rules."

In adopting the rules, the SEC cites the main harms it has observed within the private fund industry as the opacity of private fund investments, the problems raised by certain conflicts of interest and the lack of governance mechanisms within private fund structures to address investor oversight.[1]

During the comment period, the SEC received extensive comments from a wide range of industry participants, many of whom largely opposed the additional requirements these rules, as proposed, would impose on private fund advisers and cited their concerns about the pernicious consequences these rules may have, especially as proposed.[2]

Key Differences From Proposed Rules

Differences from the SEC's proposed rules in February 2022 (the "Proposed Rules")[3] include:

– *Elimination of Negligence Standard for Exculpation and Indemnification*: As a result of significant industry pushback in the comment process, the SEC dropped its proposed prohibition on a private fund adviser's seeking reimbursement, indemnification,

[1] Private Fund Advisers; Documentation of Registered Adviser Compliance; Advisers Act Release No. 6383, 16-19 (Aug. 23, 2023) ("Adopting Release"), https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.
[2] Adopting Release at 627 (noting commenters expressed concern regarding numerous issues the imposition of the rules would raise, including the negative effects the rules may have on competition for private fund advisers).
[3] Private Fund Advisers; Documentation of Registered Adviser Compliance Reviews; Advisers Act Release No. 5955 (Feb. 9, 2022), https://www.sec.gov/files/rules/proposed/2022/ia-5955.pdf.

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exculpation or limitation of liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness.

- *Elimination of Prohibition on Charging Fees for Services Not Provided*: The SEC also dropped its proposed prohibition on charging a portfolio investment for fees with respect to services that the adviser does not provide, or reasonably expects to provide, to the portfolio investment.
- *Disclosure and Consent Rather Than Prohibitions*: The SEC changed the remaining "Prohibited Activities" under the Proposed Rule to "Restricted Activities," which require either investor consent for some such activities (such as charging a private fund for fees or expenses associated with an investigation and borrowing from a private fund client) or *detailed disclosure to investors* for other such activities (such as charging the private fund with regulatory, examination or compliance fees or expenses, use and impact of "after-tax" clawbacks, and charging fees or expenses related to a portfolio investment on a non-pro rata basis), as further detailed below.
- *Changes to Quarterly Statements*: The SEC made some changes to the Quarterly Statement Rule in response to comments: (i) advisers to illiquid funds are required to calculate performance information with and without the impact of fund-subscription facilities; (ii) the definition of "illiquid fund" is now based primarily on withdrawal and redemption capability; (iii) advisers are only required to present liquid fund performance for a 10-year lookback period as opposed to since inception; and (iv) additional time was provided for the delivery of fourth quarter statements (and the delivery of all statements for funds of funds).[4]
- *Grandfathering*: Unlike the Proposed Rules, the final rules provide for grandfathering of private funds that commence their operations before the compliance date, solely for the prohibitions of the Preferential Treatment Rule and for activities under the Restricted Activities Rule that require investor consent. Additional details on grandfathering and compliance dates are below.
- *CLOs and Other Securitization Vehicles Are Now Excluded:* Advisers will not be required to comply with the requirements of the final rules with respect to securitized asset funds such as collateralized loan obligations ("CLOs").

Summary of Final Rules

Rules Applicable to All Private Fund Advisers (including ERAs):

- **Restricted Activities Rule**: Rule 211(h)(2)-1 was called the "Prohibited Activities Rule" in the Proposed Rules but is now called the "Restricted Activities Rule" to reflect the

[4] Adopting Release at 22.

departure from the flat-out prohibitions of certain activities of private fund advisers, and it will now be subject to disclosure or consent exceptions.[5]

- Prohibited activities subject to **consent** exceptions include:
    - *Charging or allocating, to the private fund, fees or expenses associated with an investigation of the adviser* is prohibited but is subject to a consent exception: the adviser seeks consent from all investors and obtains written consent from a majority in interest of the private fund's investors that are not related persons of the adviser.[6] The caveat to this rule is that 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.[7]
    - Borrowing or receiving an extension of credit from a private fund client is prohibited but subject to a disclosure and consent exception: (i) the adviser distributes a written notice and description of material terms of the borrowing to the private fund investors, and (ii) the adviser obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser.[8]
- Prohibited activities subject to **disclosure** exceptions include:
    - *Charging or allocating, to the private fund, regulatory, examination or compliance fees or expenses of the adviser is prohibited but subject to a disclosure exception: the adviser* distributes a written notice of any such fees or expenses and the resulting dollar amount to investors in writing on at least a quarterly basis.[9]
    - *Reducing the amount of an after-tax adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders* is prohibited but subject to a disclosure exception: the adviser distributes a written disclosure to the investors that sets forth the pre-tax and post-tax amount of the clawback within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.[10]
    - *Charging or allocating fees or expenses related to a portfolio investment on a non-pro rata basis when multiple funds and other clients advised by the adviser or its related persons have invested in the same portfolio investment* is prohibited but subject to two exceptions, one of which is disclosure-based: (i) the allocation approach is fair and equitable, and (ii) the adviser

[5] *Id.* at 25.
[6] *Id.* at 236-37, 655-56.
[7] *Id.*
[8] *Id.* at 243-46.
[9] *Id.* at 212.
[10] *Id.* at 223.

distributes advance written notice of the non-pro rata charge and a description of how the allocation approach is fair and equitable under the circumstances.[11]

- **Preferential Treatment Rule:** Rule 211(h)(2)-3 prohibits advisers from the following:
  - *Preferential Redemptions*: granting an investor in a private fund (or in a substantially similar pool of assets) 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 (subject to two exceptions: (i) for redemptions required by applicable law, rule or regulation, and (ii) if the adviser offering the same redemption ability to all existing investors and all future investors in the private fund or any similar pool of assets);[12]
  - *Preferential Portfolio Information:* providing information on portfolio holdings or exposures of a private fund (or of a substantially similar pool of assets) to any investor if the adviser reasonably expects that the information would have a material, negative effect on other investors in that private fund (unless the adviser offers the same information to all other existing investors in the private fund and any similar pool of assets at the same or substantially the same time[13]); and
  - Other Preferential Terms Without Disclosure to Investors: providing any other preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors regarding all preferential treatment the adviser and its related persons provide to other investors in the same fund.[14] This includes (i) providing advance written notice to prospective investors of material economic terms and (ii) providing all current investors with comprehensive, annual disclosure of all preferential treatment provided by the adviser or its related persons since the last annual notice.[15]
- **Grandfathering:** Private funds that commenced their operations as of the compliance date (i.e., 12 months or 18 months after the rule is published, depending on the size of the adviser's private fund assets under management ("AUM")) are "grandfathered" (referred to by the SEC as "legacy status") and thus not required to comply with (i) the prohibitions aspect of the Preferential Treatment Rule and (ii) the aspects of the Restricted Activities Rule that require investor consent (except for charging for fees or expenses related to an investigation that results in a sanction for a violation of the Advisers Act or its rules).[16] The

[11] *Id.* at 224-26.
[12] *Id.* at 261, 263.
[13] The SEC noted that this exception should allow advisers to discuss their portfolio holdings during investor meetings, so long as all investors have access to the same information. Adopting Release at 263.
[14] *Id.* at 261.
[15] *Id*. at 261,263.
[16] *Id.* at 316-17.

commencement of operations of a fund includes any bona fide activity directed at operating a private fund, such as investment, fundraising or operational activity.[17] This can include conducting due diligence on potential fund investments.

Grandfathering, however, does not apply to the other final rules, as the Commission believes the other rules will not require private fund advisers or investors to amend binding contractual agreements.[18] Further, the legacy status does not apply to the transparency portions of the Preferential Treatment Rule, and as a result, information in side letters that existed before the compliance date will need to be disclosed to other investors that invest in the fund after the compliance date (this information can be anonymized). Grandfathering applies only with respect to advisers' "existing agreements with parties as of the compliance date," which means that an adviser may not add new parties to an existing side letter after the compliance date.[19] A fund may still admit new investors without violating the legacy provisions to the extent the applicable terms are set forth in the fund's governing documents and applicable to all investors.[20]

Rules Applicable Only to Registered Private Fund Advisers:

- **Quarterly Statement Rule:** Rule 211(h)(1)-2 requires that a registered investment adviser prepare and distribute quarterly statements for any private fund that it advises with certain information for the prior quarterly period regarding (i) the fund's fees and expenses, (ii) any compensation paid or allocated to the adviser or its related persons by the fund, and (iii) any compensation paid or allocated by the fund's underlying portfolio investments.[21] Much of this information must be presented in a tabular format, as prescribed by Rule 211(h)(1)-2. The quarterly statements must be distributed to investors of private funds that are not funds of funds within 45 days after the first three fiscal quarter-ends and 90 days after the end of each fiscal year.[22]

  Additionally, the rule requires registered advisers, in each quarterly statement provided to fund investors, (i) for liquid funds, to show performance 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 over one-, five- and 10-fiscal-year periods, and on a cumulative basis for the current fiscal year, as of the end of the most recent fiscal quarter; and (ii) for illiquid funds, to show performance based on internal rates of return and multiples of invested capital since inception, and to present a statement of contributions and distributions.[23]

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[17] *Id.*
[18] *Id.* at 319.
[19] *Id.*
[20] *Id.* As a practical matter, there are questions about what "applicable to all investors" means in this context, considering the legacy status of certain side letter arrangements.
[21] *Id.* at 74.
[22] *Id.* at 145.
[23] *Id.* at 104-5.

In addition, under the rule, a registered adviser serving as sub-adviser would need to comply with the quarterly statement rule with respect to a private fund whose primary adviser is not subject to the rule.[24]

- **Private Fund Audit Rule:** Rule 206(4)-10 requires that registered private fund advisers obtain an annual financial statement audit of the private funds they advise, directly or indirectly. The annual financial statement audit must meet the requirements set forth in (b)(4)(i) through (b)(4)(iii) of Rule 206(4)-2 (the "Custody Rule"),[25] and these audited financial statements must be delivered in accordance with paragraph (c) of the Custody Rule.

  In short, the requirements of the annual financial statement audit are that (i) the audit must be performed by an independent public accountant that meets the standards of independence of rule 2-01(c) and (d) of Regulation S-X and is registered with and subject to regular inspection by the Public Company Accounting Oversight Board in accordance with its rules; (ii) the audit must meet the definition of an audit contained in rule 1-02(d) of Regulation S-X; (iii) the audited financial statements must be prepared in accordance with generally accepted accounting principles; and (iv) the audit must be delivered annually, within 120 days of the private fund's fiscal year-end and promptly upon liquidation, to investors of the private fund.[26]

  The SEC also clarified that if a fund is already undergoing an audit, a sub-adviser (or other non-control adviser) does not have to take reasonable steps to cause its private fund client to undergo an audit. However, if the private fund does not otherwise undergo an audit, an adviser must take all reasonable steps to cause its private fund client to undergo an audit that satisfies the rule when the adviser does not control the private fund and is neither controlled by nor under common control with the fund.[27] The SEC notes that, for example, a sub-adviser that has no affiliation to the general partner of a private fund could document the sub-adviser's efforts by including (or seeking to include) the requirement in its sub-advisory agreement.[28]

- **Adviser-Led Secondaries Rule:** Rule 211(h)(2)-2, which applies to "adviser-led secondaries" by registered advisers, requires a registered adviser to obtain a fairness or valuation opinion from an independent opinion provider and distribute the opinion to private fund investors in advance.[29] Such registered advisers must also prepare and

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[24] *Id.* at 70 note 197.
[25] In February 2023, the SEC proposed amendments to the Custody Rule in the proposed Rule 223-1 of the Advisers Act (the Safeguarding Rule). The SEC reopened the comment period for the Safeguarding Rule that was proposed in February. See Safeguarding Advisory Client Assets; Reopening of Comment Period, Advisers Act Release No. 6384 (Aug. 23, 2023).
[26] Adopting Release at 163-64.
[27] *Id.* at 184.
[28] *Id.* at 185.
[29] *Id.* at 186. "Adviser-Led Secondaries" are transactions that offer fund investors the choice of either selling all or a portion of their interests in the private fund or converting or exchanging them for new interests in another vehicle advised by the adviser or its related persons.

distribute a written summary of any material business relationships the adviser or its related persons has, or has had, with the independent opinion provider within the two years before the issuance of the fairness or valuation opinion.[30] Both the opinion and the summary of material business relationships must be distributed to private fund investors prior to the due date of the election form for the transaction, which is a change from the Proposed Rules.[31]

– **Recordkeeping Rule**: The existing Advisers Act Recordkeeping Rule, Rule 204-2, is amended to require registered advisers to retain books and records with respect to:

  - The Quarterly Statement Rule: retaining copies of quarterly statements distributed to fund investors, records of each addressee and the date(s) the statements were sent; records evidencing the calculation method for all expenses, allocations, offsets, waivers and performance listed in any quarterly statement; and records substantiating an adviser's determination that a private fund client is liquid or illiquid;[32]
  - The Audit Rule: retaining copies of the audited financial statements with a record of each addressee and the corresponding date(s) these were sent;[33]
  - The Adviser-Led Secondaries Rule: retaining copies of the fairness or valuation opinion and the material business relationship summary distributed to investors, and records of each addressee and the date the opinion and the summary were sent;[34]
  - The Restricted Activities Rule: retaining copies of any notification, consent or other document distributed to or received from private fund investors pursuant to this rule;[35] and
  - The Preferential Treatment Rule: retaining copies of all written notices sent to current and prospective investors of a private fund pursuant to this rule.[36]

– **Compliance Rule Amendments:** As proposed, the SEC's rulemaking package also included a new requirement under the Rule 206(4)-7 (the "Compliance Rule"), which is applicable to all registered advisers (regardless of whether they are advisers to private funds). The amendments to the Compliance Rule mandate that advisers document their annual review *in writing*.

Deadlines for Compliance (Compliance Dates)

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[30] *Id.* at 201.
[31] *Id.* at 202-3.
[32] *Id.* at 159-60.
[33] *Id.* at 185-86.
[34] *Id.* at 204.
[35] *Id.* at 210.
[36] *Id.* at 301.

- Restricted Activities Rule, Preferential Treatment Rule and Adviser-Led Secondaries Rule:[37]
    - For advisers with $1.5 billion or more in private fund AUM: 12 months
    - For advisers with less than $1.5 billion in private fund AUM: 18 months[38]
- Quarterly Statement Rule and Private Fund Audit Rule: 18 months
- Compliance Rule: 60 days

  (Periods are measured beginning on the date when the rules are published in the Federal Register.)

Initial Observations and Commentary

Statutory Authority

Some in the industry have questioned the authority of the Commission to adopt rules that effectively regulate the activities, reporting and disclosures of private funds.

- The Commission based its authority on:
    - Section 206(4) of the Advisers Act, which provides authority to adopt rules "reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative";[39] and
    - Section 913(g) of the Dodd-Frank Act, which added Section 211(h) of the Advisers Act, which provides authority to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with… investment advisers" and "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."[40]
- In her dissenting statement, Commissioner Peirce disagrees with these findings of authority.[41] Specifically, Commissioner Peirce cites a lack of statutory authority under Section 913(g) of the Dodd-Frank Act, which is within a subsection titled "Authority to Establish a Fiduciary Duty for Brokers and Dealers" and was added to the Dodd-Frank Act

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[37] *Id.* at 308.
[38] *Id.* at 308-9. The 18-month period takes into account that these rules require advisers to enter into new, or renegotiate existing, contracts with third-party service providers, like accountants and administrators.
[39] 15 U.S.C. 80b-6(4).
[40] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat 1376 (Jul. 21, 2010) ("Dodd-Frank Act"), § 913(g).
[41] Commissioner Hester M. Peirce, *Uprooted: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, SEC (Aug. 23, 2023), https://www.sec.gov/news/statement/peirce-statement-doc-registered-investment-adviser-compliance-reviews-08232023 ("Commissioner Peirce Statement").

to address concerns around standards of care for retail investment advisers and broker-dealers. She notes that although this section used the terms "investors," Section 913 makes numerous references to retail investors, which, in her view, indicates the fact that the whole section is retail-oriented. Commissioner Peirce also objected to the use of Section 206(4) of the Advisers Act to mandate private fund audits and noted that this results in violations of routine compliance obligations turning into enforcement actions because Section 206 is an antifraud provision.

Fundamental Shift in Regulation of Private Funds

Although the Private Fund Adviser Rules are milder than the Proposed Rules, they represent a significant expansion of the regulatory requirements applicable to private fund advisers. While the rules shift to more of a disclosure and consent regime than would have been the case under the Proposed Rules, the 660-page Adopting Release still contains many prescriptive requirements regarding the new disclosure rules. Many of these new requirements are buried in footnotes throughout the Adopting Release.[42] The standards articulated in these footnotes provide for granular requirements regarding line items, titling, description and timing of disclosure. Some of the requirements may make the disclosure regime impractical and effectively operate as a prohibition.[43]

For example:

- Written notice of regulatory, compliance or examination fees and expenses of the adviser or its related persons should "generally list each specific category of fee or expense as a separate line item and the dollar amount thereof, rather than group such fees and expenses into broad categories such as 'compliance expenses.'"[44]
- If an adviser charges a fund for fees and expenses associated with the preparation and filing of the adviser's Form ADV, this disclosure cannot be included in a broad category such as "legal expenses."[45]
- In seeking investor consent for the purpose of charging a fund with fees and expenses associated with an investigation of the adviser or its related persons by a regulatory authority, "advisers generally should list each category of fee or expense as a separate line item, rather than group fund expenses into broad categories, and *describe how each such fee or expense is related to the relevant investigation*."[46]
- Even in such circumstances where investigation fee and expense allocation provisions are highly negotiated by investors, such negotiation "is only effective if investors explicitly consent to any such allocations *in each specific instance*."[47]

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[42] *See, e.g.,* Adopting Release at notes 630, 642, 703, 716.
[43] *Id.* at 240 note 716.
[44] *Id.* at 212 note 630.
[45] *Id.* at 215 note 642.
[46] *Id.* at 237 note 703 (emphasis added).
[47] *Id.* at 240 note 716 (emphasis added).

The rules fundamentally shift the nature of the investor–sponsor relationship that has long been applicable to private funds, where the long-standing practice has been for institutional and other sophisticated investors to negotiate fund terms and conditions with fund sponsors. The SEC is now inserting itself and shifting the balance of these negotiations in a manner that is likely to have unintended consequences and costs for the industry as a whole. In addition to shifting the nature and dynamics of investor negotiations, the new disclosure requirements also push private funds in a more retail direction and, in some instances, beyond the existing disclosure framework applicable to retail funds. Moreover, the SEC does so indirectly under the Advisers Act, seemingly bypassing altogether the Investment Company Act of 1940 and the direct regulation of private funds thereunder.

Both of the dissenting Commissioners addressed these fundamental shifts:

- Commissioner Peirce commented that the rules maim the regulatory framework by imposing a prescriptive regime that is "unnecessary government interferences in, and sometimes outright bans of, well-established practices."[48] Her opening statement characterized the Private Fund Adviser Rules as "ahistorical, unjustified, unlawful, impractical, confusing, and harmful."[49] She also took specific issue with the purpose of the Preferential Treatment Rule.
- Commissioner Uyeda questioned why the Commission is imposing rules on private funds—which are generally only available for sophisticated investors—that are more restrictive than products for retail investors.[50] Similarly, Commissioner Peirce questioned the notion present in the rules that accredited investors and qualified purchasers—which are selective groups—cannot "fend for themselves" in a way that retail investors were thought not to be able to do.[51] Commissioner Uyeda noted that the rules appear to contain the premise that sophisticated investors have "less bargaining power" than others and that the rules will interfere with the abilities of sophisticated investors to invest in private funds.[52]
- Commissioner Uyeda also noted that the House Appropriations Committee encouraged the Commission to reconduct its economic analysis to consider the disproportionate impact the Proposed Rules would have on minority and women-owned asset management firms, but he found it unfortunate that the Commission dismissed this concern by suggesting that advisers can just reduce their AUM to avoid registration and the costs of the rules that apply to registered advisers.[53]

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[48] Commissioner Peirce Statement.
[49] *Id.*
[50] Commissioner Mark T. Uyeda, *Statement on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, SEC (Aug. 23, 2023), https://www.sec.gov/news/statement/uyeda-statement-private-fund-advisers-082323 ("Commissioner Uyeda Statement").
[51] Commissioner Peirce Statement.
[52] Commissioner Uyeda Statement.
[53] *Id.*

Costs to Advisers and Investors

Throughout the Adopting Release, the Commission highlights that many, if not most, commenters pointed out that compliance with the Private Fund Adviser Rules will significantly increase costs for private funds, which will ultimately be passed on to investors.[54] The Commission recognized the significant increase in compliance costs: it is estimated that the Quarterly Statement Rule will impose more than $487 million in aggregate annual costs on advisers for the preparation and distribution of the quarterly statements,[55] while compliance with the Private Fund Audit Rule will impose more than $473 million in actual economic costs.[56] In the case of the Restricted Activities Rule, the Commission was unable to provide a total estimate for the compliance costs due to the numerous variables involved.[57]

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Please contact a lawyer in WilmerHale's Investment Management Group or Securities Department should you have any questions on the Private Fund Adviser Rules or their potential implications.

[54] Adopting Release at 66-7.
[55] *Id.* at 442-43.
[56] *Id.* at 527.
[57] *Id.* at 496-97.

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