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Client Insight: SEC Adopts New Private Fund Adviser Rules and Amendments under the Investment Advisers Act of 1940

Insights
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On August 23, 2023, the Securities and Exchange Commission (the "***SEC***") adopted new private fund adviser rules and amendments (the "***Final Rules***") under the Investment Advisers Act of 1940 (the "***Advisers Act***"), which were first proposed in February 2022 (the "***Proposed Rules***"). The following are our initial impressions of the Final Rules.

Key Takeaways

At a high level, the Final Rules are significantly scaled back from the Proposed Rules with many practices that would have been prohibited under the Proposed Rules now allowed, provided that additional disclosure is provided to investors. Nevertheless, while the Final Rules are significantly scaled back from the Proposed Rules, the Final Rules significantly increase regulatory obligations for all investment advisers to private funds, including exempt reporting advisers ("***ERAs***"). The Final Rules add new requirements related to investor reporting, private fund audits and third party opinions in advance of adviser-led secondaries, and increase compliance burdens and documentation requirements related to annual compliance reviews. Furthermore, the Final Rules impose restrictions on certain activities including practices related to fees and expenses and expense allocations, and also on the ability to provide preferential terms to one or more investors. Please note that as described in more detail below, most of these rules take effect in 12 or 18 months and none of these rules take effect immediately.

Requirements Applicable to All Private Fund Advisers

Restricted Activities Rule

The SEC has adopted the new Advisers Act Rule 211(h)(2)-1 (the "***Restricted Activities Rule***"). The Restricted Activities Rule prohibits all private fund advisers, including ERAs and foreign private advisers (but excluding offshore clients of offshore advisers, whether or not those offshore funds have U.S. investors), from engaging in certain activities. However, unlike the prohibited activities rule in the Proposed Rules, the Restricted Activities Rules allow for certain carve-outs for investor disclosure and consent.

Specifically, the following activities are restricted:

- Charging or allocating to a private fund fees or expenses associated with an investigation of the adviser or its related person by any governmental or regulatory authority without disclosure and consent from fund investors. Regardless of whether consent is obtained, an adviser may not charge to a fund any 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;
- Charging or allocating to a private fund any regulatory, examination or compliance fees or expenses of the adviser, unless such fees and expenses are disclosed to investors;
- Reducing the amount of an adviser's clawback by the amount of certain taxes, unless the adviser discloses the pre-tax and post-tax amount of the clawback to investors;
- Charging or allocating fees or expenses related to an investment in a portfolio company on a non-pro rata basis when multiple private funds have all invested in such portfolio company and are advised by the adviser, unless the allocation approach is fair and equitable and the adviser 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; and
- Borrowing money, securities or other private fund assets, or receiving a loan or extension of credit from a private fund client without disclosure to, and consent from, fund investors.

Notably, where investor consent is required (*i.e.,* in the first and last bullet points above), an adviser must seek consent from all of a fund's investors and obtain consent from at least a majority in interest of investors that are not related persons of

the adviser. Advisory board or "LPAC" consent is not sufficient for these purposes, and it appears that consent is required even in cases where the applicable governing document of the private fund expressly allows the adviser to take the action in question (*e.g.,* where the fund's limited partnership agreement allows reimbursement of expenses associated with an investigation of the adviser or allows the adviser to borrow from the fund).

In a conforming amendment, Advisers Act Rule 204-2 (the "***Books and Records Rule***") has been amended to require that SEC registered investment advisers ("***RIAs***") retain books and records to document their compliance with the disclosure and consent aspects of the Restricted Activities Rule.

Effective Date: The compliance date for the Restricted Activities Rule for advisers with $1.5 billion or more in private fund assets is 12 months after the date of publication in the Federal Register and for advisers with less than $1.5 billion in private fund assets, 18 months after publication in the Federal Register.

Preferential Treatment Rule

The Final Rules include new rule 211(h)(2)-3 (the "***Preferential Treatment Rule***"). The Preferential Treatment Rule imposes additional requirements on advisers that provide preferential terms to one or more investors through side letters or otherwise. Certain preferential terms are outright prohibited.

Specifically, the Preferential Treatment Rule prohibits an adviser from granting an investor in a private fund or similar pool of assets preferential liquidity or redemption rights that could reasonably be expected to have a material, negative effect on other investors in the fund or similar pool unless (1) the ability to redeem is required by applicable laws, rules, regulations, or orders of any foreign or U.S. government, state, or political subdivision to which the investor is subject or (2) the investment adviser has offered the same redemption right to all investors in the private fund and any similar pool of assets. While the language of the Preferential Treatment Rule could be clearer on this point, it appears that the rule is not intended to prohibit the types of redemption rights typically granted in the venture capital or private equity context (*e.g.,* redemption rights in the event of a violation of ERISA or other regulations).

The Preferential Treatment Rule similarly prohibits an adviser from providing preferential information rights related to portfolio holdings or exposures of a private fund or a similar pool of assets to any investor if the adviser reasonably believes that providing the information would have a material, negative effect on other investors in the private fund or in a similar pool of assets, unless the adviser offers such information to all existing investors in the private fund and any similar pool of assets.

The SEC declined to define "material, negative effect" and in practice could interpret this provision broadly. Nevertheless, in the case of a portfolio company that is not publicly traded, it is not immediately apparent how the type of portfolio company information that is typically disclosed to investors that have negotiated for special information rights would normally have a material, negative effect on other investors. In fact, though the SEC declined to provide a blanket exemption for all closed-end funds, in the Adopting Release for the Final Rules, the SEC indicated that they would generally not view preferential information rights provided to one or more investors in an illiquid private fund as having a material, negative effect on other investors.

All other preferential treatment is prohibited unless the adviser (1) provides advance written notice of all existing negotiated preferential treatment to all prospective investors in a private fund before the time of their investment (*e.g.,* the adviser must provide disclosure to second close investors of all preferential rights negotiated with first close investors) and (2) discloses all preferential treatment to current investors in an illiquid fund,[1] such as a venture capital fund or other private equity fund, as soon as practical after the fundraising period (*i.e.*, all investors must receive notice of all preferential rights negotiated with other investors). On an annual basis, private fund advisers must send a written notice to all investors regarding any preferential treatment provided by the adviser to other investors in the same fund since the last written notice was provided. When disclosing this data, advisers may both summarize and anonymize preferential terms.

Notably, while the SEC has not precisely defined "similar pool of assets[2]," the definition is intended to be very broad and is designed to capture most commonly used private fund structures to prevent advisers from structuring around prohibitions on preferential treatment. The Adopting Release indicates that custom feeders for favored investors, certain co-investment vehicles, and in some instances private funds with different strategies or areas of focus would constitute similar pools of assets.

Effective Date: The compliance date for the Preferential Treatment Rule for advisers with $1.5 billion or more in private fund assets is 12 months after the date of publication in the Federal Register and for advisers with less than $1.5 billion in private fund assets, 18 months after publication in the Federal Register.

Legacy Status

Unlike under the Proposed Rules, the Final Rules provide for legacy status or "grandfathering" related to preferential treatment and restricted activities. Under legacy status provisions, no amendments are required for fund governing documents that were or are entered into prior to the applicable compliance date, provided the

fund had also commenced operations (which includes, among other things, fundraising, holding an initial closing, conducting diligence on potential investments, or making an investment) as of such compliance date. For such funds, the SEC is providing legacy status for the aspects of the Restricted Activities Rule that require investor consent.

Legacy status does not extend to the disclosure portions of the Preferential Treatment Rule. Consequently, preferential terms in side letters that existed before the compliance date must be disclosed to new investors investing after the compliance date, and such disclosure must be made prior to the time that such new investors are admitted to the fund. It appears that even funds that have effected a final closing prior to the compliance date will have to provide a summary of all preferential rights granted to all investors. Similarly, legacy status does not apply to the other disclosure requirements contained in the Restricted Activities Rule.

Finally, Legacy status does not permit an adviser to charge a fund for fees or expenses related to an investigation that results in a sanction for violation of the Advisers Act.

Requirements Applicable to Registered Private Fund Advisers (excludes ERAs and foreign private advisers)

Quarterly Statement Rule

The Final Rules impose quarterly fund level reporting requirements on RIAs. Specifically, the rules require that RIAs to closed-end (*i.e.,* illiquid) funds provide the following information to all investors in a table format on a quarterly basis within 45 days after the end of each fiscal quarter and within 90 days of the end of each fiscal year of the private fund.[3] Under the Final Rules, the following information must be presented both before and after the application of any offsets, rebates, or waivers:

- accounting of all compensation, fees, and other amounts paid to the investment adviser or its related persons[4] during the reporting period;
- accounting of all other fees and expenses allocated to or paid by the private fund during the reporting period (*e.g.,* legal, tax, investment diligence);
- the amount of any fee offsets or rebates carried forward during the reporting period to subsequent periods;
- a detailed accounting of all portfolio investment compensation allocated or paid to the investment adviser or its related persons by each portfolio company that paid the adviser or its related persons compensation during the reporting period; and

- standardized performance information including gross and net MOIC, gross and net IRR, and gross IRR and gross MOIC for the unrealized portions of an illiquid fund's portfolio.

Performance metrics in such reports must exclude the impact of any fund-level subscription facility and be calculated as if the fund called capital rather than drawing down from a facility. All assumptions used when calculating performance must be disclosed. Notably, reporting at the investor level is not required though advisers may optionally continue to provide such individualized reporting (e.g. an investor's capital account balance, share of expenses, or similar investor specific information).

Effective Date: The compliance date for the quarterly statement rule is 18 months after the date of publication in the Federal Register.

Private Fund Audit Rule

The Final Rules amend Advisers Act Rule 206(4)-10 and require that all RIAs obtain annual private fund audits of each of advised private fund prepared in accordance with U.S. Generally Accepted Accounting Principles ("***GAAP***") by a Public Company Accounting Oversight Board ("***PCAOB***") registered independent public accounting firm. In practice, most RIA private fund managers have historically relied on the audit provision under the Custody Rule and as such, this requirement will likely have limited impact on most private fund advisers.

Effective Date: The compliance date for the private fund audit rule is 18 months after the date of publication in the Federal Register.

Adviser-led Secondaries Rule

The Final Rules impose additional requirements on all adviser-led private fund secondary transactions.[5] Specifically, private fund advisers must obtain and distribute to all investors a third-party fairness opinion or valuation opinion and a summary of material business dealings with the provider of such opinion in advance of the closing of the secondary transaction.

Effective Date: The compliance date for the adviser-led secondaries rule for advisers with $1.5 billion or more in private fund assets is 12 months after the date of publication in the Federal Register and for advisers with less than $1.5 billion in private fund assets, 18 months after publication in the Federal Register.

Books and Records Rule Amendments

The Final Rules amend the Books and Records Rule to require that RIAs retain books and record related to the quarterly statement rule including copies of quarterly statements distributed to fund investors, as well as a record of each addressee and the date each statement was sent. RIAs must also retain records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance on such quarterly statements. RIAs must retain documentation substantiating the adviser's determination that a private fund client is a liquid fund or an illiquid fund.

Requirements Applicable to All RIAs

Compliance Rule Amendments

The Final Rules amend Advisers Act rule 206(4)-7 (the "***Compliance Rule***") to require that all RIAs document their annual compliance review in writing. This amendment was adopted as proposed and given that most RIAs document the annual review, is not expected to have a material impact on most RIAs' compliance practices.

Effective Date: The compliance date for the amended Compliance Rule is 60 days after publication in the Federal Register.

Notable Provisions of the Proposed Rules that Were Substantially Relaxed or Deleted from the Final Rules

- After-tax Clawbacks: The Final Rules do not prohibit after-tax clawbacks and instead merely require that investors receive notice of the dollar amounts of the gross clawback and after-tax amount within 45 days of the end of the quarter in which the clawback payment occurred.
- Limitation of Liability/Indemnification: The Final Rules do not contain the prohibitions on indemnification/exculpation that were included in the Proposed Rules. The Adopting Release does note in the commentary that advisers are still not able to waive their federal fiduciary duties, but there is no new rule-making on this point.
- Borrowing and Fees for Investigations: Instead of prohibiting an adviser from borrowing from a fund and obtaining reimbursement for expenses related to an investigation of an adviser, these transactions can now be effected with investor consent.
- Unperformed Services: The SEC dropped the prohibition against fees for unperformed services, although they did note that they viewed these fees as

restricted by an adviser's fiduciary duty.

- Adviser-led Secondaries: In lieu of requiring a fairness opinion, the Final Rules now allow an adviser to obtain a valuation opinion in lieu of a fairness opinion.

- Grandfathering and Effective Dates: As described in more detail above, the Final Rules now allow for limited "grandfathering" so that some of the new provisions will not be applicable to legacy funds. In addition the rule has reasonably generous timing dates, giving smaller funds 18 months and larger funds 12 months to come into compliance with various provisions.

Please reach out to insights@gunder.com or your primary Gunderson attorney if you have any questions regarding these new private fund adviser rules.

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[1] Illiquid funds (*i.e.,* closed-end funds) are defined to mean private funds that are not required to redeem interests upon an investor's request and that have limited opportunities for investors to withdraw before termination of the fund.
[2] fund The Fina Rules define similar pool of assets to mean a pooled investment vehicle with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser.
[3] Funds of Funds are required to distribute quarterly statements within 75 days of the end of the 1st, 2nd, and 3rdquarters and within 120 days of the end of each fiscal year.
[4] Related persons include the adviser's officers, partners, directors, persons with similar functions, persons controlling, controlled by or under common control, and all employees other than those engaging in purely administrative functions.
[5] Adviser-led secondary transactions are defined as transactions initiated by the adviser or its related persons that offer the private fund's investors the choice between (i) selling all or a portion of their interests in the private fund or (ii) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

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