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SEC Adopts Significant New Rules for Private Fund Advisers

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The SEC adopted new and amended rules that will have a substantial impact on investment advisers to private funds.

The SEC has adopted new and amended rules under the Investment Advisers Act of 1940 (Advisers Act) significantly increasing the regulatory burden of private fund advisers whether registered, not registered or Exempt Reporting Advisers.

The new rules primarily address the following areas:

- Requirements to prepare and distribute quarterly statements;
- Audit requirements;
- Conditions to adviser-led secondaries;
- Restrictions on certain activities, including recovery of expenses and borrowing arrangements with funds; and
- Restrictions on preferential treatment of fund investors.

Registered Private Fund Advisers

The new rules and disclosure obligations applicable to registered private fund advisers (but not Exempt Reporting Advisers) include:

Quarterly Statements. The new rules require a registered private fund adviser to prepare and distribute a quarterly statement that includes specified information regarding fees, expenses and performance for any private fund it advises. The quarterly statements are to be sent to the fund's investors within 45 days after the end of each of the first three calendar quarters and within 90 days after the end of each fiscal year. Newly formed private funds will first have to comply after its second full fiscal quarter of generating operating results. Quarterly statements will have to address the following:

Fees and Expenses

For the Fund. A detailed accounting of all compensation paid or allocated to the adviser and related persons, fund fees and expenses and any fee offsets or rebates during the reporting period.

For Portfolio Investments. A detailed accounting of all compensation paid or allocated by a private fund's portfolio investments to the adviser.

Cross References. Prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers and offsets are calculated, as well as cross-references to those calculation methodologies in the private fund's organizational and offering documents.

Performance Information. Standardized information regarding the private fund's performance calculated on the basis of whether a fund is a liquid fund or an illiquid fund.[1] Including prominent disclosure of the criteria used and assumptions made in calculating the performance.

Liquid Funds must provide:

- annual net total returns for each fiscal year over the past 10 fiscal years or since inception (whichever is shorter),
- average annual net total returns over one, five, and ten-year fiscal periods, and
- the cumulative net total return for the current fiscal year as of the most recent fiscal quarter covered by the statement.

Net returns are required to be presented; however, the Rules permit the inclusion of gross returns as well.

Illiquid Funds must provide from inception:

- gross and net internal rate of return,
- gross and net multiple of invested capital, and
- 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 Audits. The new rules require registered private fund advisers to cause the private funds they advise to undergo a financial statement audit, and deliver audited financial statements to private fund investors consistent with the audit provision in the Custody Rule (Rule 206(4)-2 under the Advisers Act). Consequently, the SEC noted in the Adopting Release "a surprise examination under the custody rule does not satisfy the requirements of [the new rules]."

Adviser-Led Secondaries. The new rules add a fairness or valuation opinion requirement for adviser-led secondaries where private fund advisers offer existing fund investors the option to sell or exchange their interests in the fund for interests in another vehicle advised by the adviser. The fairness or valuation opinion is to be provided by an independent opinion provider. The adviser must also prepare a summary of any material business relationships the adviser or any of its related persons has, or has had, with the independent opinion provider within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion. Both the summary and the fairness or valuation opinion must be delivered to investors prior to the date investors must indicate whether they wish to participate in the transaction.

All Private Fund Advisers – Restricted Activities

Under the new rules, the SEC prohibited a variety of activities. However, there are some exceptions based either on disclosure to investors, or disclosure accompanied by investor consent.

Prohibited Conduct.

The SEC provided absolute prohibitions on certain types of preferential treatment of private fund investors or investors in a "similar pool of assets" in two categories, preferential redemption rights and preferential information rights. In this regard, the SEC indicated that the new term "similar pool of assets" is intended to "capture most commonly used private fund structures (or similar arrangements) and prevent advisers from structuring around the prohibitions on preferential treatment."[2]

Preferential Information Rights. The new rules prohibit a private fund adviser from providing information regarding the portfolio holdings of the private fund to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a similar pool of assets. The SEC noted that an adviser providing preferential information about a fund's holdings to an investor, who used that information to redeem its fund interests, would be a material, negative effect to the other fund investors. Here, the SEC noted that preferential information rights alone were unlikely to trigger the material, negative effect provision, that it was more likely that preferential information rights would have an effect if coupled with an ability to redeem fund interests. Further, the SEC indicated that for illiquid funds, preferential information would be unlikely to be viewed as having a material, negative effect on other investors.

Preferential Redemption Rights. The new rules prohibit a private fund adviser from providing preferential redemption rights on terms that the adviser reasonably expects to have a material, negative effect on other investors in the private fund or in a similar pool of assets. However, the new rules provide an exception for the following two circumstances:

- where the redemption rights are required by law or regulation, or
- where the redemption or information rights are offered to all existing and future investors in the private fund and any similar pool of assets.

Disclosure Based Exceptions

Other Preferential Rights. Other than as discussed above with respect to preferential information and redemption rights, for all other preferential rights, the new rules may require disclosure. In the event that preferential treatment relates to any "material economic terms" that the adviser or its related persons provide to other investors in the same private fund, an investment adviser must provide written disclosure of such rights to each prospective fund investor prior to the investor's investment in the private fund. Otherwise, an investment adviser must provide disclosure to investors of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund according to fund type:

Liquid Fund. For liquid funds, investment advisers must provide, as soon as reasonably practicable following the investor's investment in the private fund, written disclosure of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund.

Illiquid Fund. For illiquid funds, investment advisers must provide, as soon as reasonably practicable

following the end of the private fund’s fundraising period, written disclosure of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund.

The SEC noted that preferential fee terms alone, would not trigger the need for disclosure unless fee differentials were linked to investor capital contributions, in which case, the elements of such fee discounting would have to be disclosed. The SEC indicated that it would be appropriate to distribute these notices within four weeks of the end of the fund’s fundraising period (for illiquid funds) or the investor’s investment in the fund (for liquid funds). To the extent that preferential fee terms were extended after the last written notice, an investment adviser must provide an update at least annually.

Regulatory, Examination, and Compliance Fees and Expenses. Absent prior written notice to fund investors within 45 days after the end of the quarter in which expenses were incurred, the new rules prohibit a private fund adviser from charging a private fund for:

- regulatory or compliance fees and expenses of the adviser or its related persons and
- fees and expenses associated with an examination of the adviser or its related persons by any governmental or regulatory authority.

Tax Setoffs for Adviser Clawbacks. Absent prior written notice to fund investors within 45 days after the end of the quarter in which adviser clawback occurred, the new rules prohibit a private fund adviser from setting off the amount of any adviser carried interest clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons or affiliates. In the Adopting Release, the SEC noted that disclosure could be delivered in the now mandated quarterly reports.

Non-Pro Rata Allocations of Fees and Expenses. The new rules prohibit a private fund adviser from charging or allocating fees and expenses related to a private fund portfolio investment held by multiple funds on an other than pro rata basis, unless:

- the charge or allocation is fair and equitable under the circumstances, and
- the Private Fund Adviser first distributes a written notice describing the allocation and how it is fair and equitable under the circumstances.

Should a private fund adviser decide to allocate fees on an other than pro rata basis, the SEC provided the following factors the adviser should consider in determining the allocation is fair and equitable:

- whether the expense relates to a specific type of security that one private fund client holds;
- whether the expense relates to a bespoke structuring arrangement for one private fund client to participate in the portfolio investment (e.g., the use of blocker funds); or
- one private fund client may receive a greater benefit from the expense relative to other private fund clients, such as the potential benefit to certain insurance investors in “rated note” feeders or parallel funds.

Disclosure and Consent Based Exceptions

Investigation Expenses. Absent:

- having sought consent from all investors of a private fund and
- having obtained such consent from a majority in interest of the fund's investors that are not affiliates of the private fund adviser,

the new rules prohibit a private fund adviser from charging private fund clients for fees and expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, even if the conduct would otherwise be indemnifiable under the applicable private fund governing documents. However, regardless of any consent, a Private Fund Adviser may not charge or allocate fees and expenses stemming from an investigation that results, or has resulted in, sanctions for violations of the Advisers Act or the rules thereunder. To the extent any such sanction occurs after a private fund adviser availed themselves of this exception, all such fees would need to be reimbursed.

Borrowing. Absent:

- having sought consent from all investors of a private fund and
- having obtained such consent from a majority in interest of the funds investors that are not affiliates of the private fund adviser,

the new rules prohibit a private fund adviser from borrowing money, securities or other private fund assets, or receiving a loan or extension of credit from a private fund. However, the SEC noted in the Adopting Release that nothing in this provision limited a private fund adviser from borrowing directly from an investor in the private fund.

All Registered Advisers

The new rules amend the Compliance Rule to require registered advisers to document their annual review of their compliance policies and procedures, which will be reviewed by the Division of Inspections during an exam.

The new rules also amend the Books and Records Rule to require registered advisers to retain records related to the Rules, including, but not limited to, required notices, quarterly statements and records evidencing the calculation method of figures included therein, audited financial statements, any fairness or valuation opinions and any books and records related to the restricted activities provision.

Compliance Date and Legacy Status

While the final rules will become effective 60 days after publication in the Federal Register, the compliance dates for the new and amended rules are as follows:

- For the audit rule and quarterly statement requirement, 18 months after publication in the Federal Register.
- For the adviser-led secondaries rule, preferential treatment rule and restricted activities rule:
  - 12 months after publication in the Federal Register for advisers with $1.5 billion or more in private funds assets under management; and
  - 18 months after publication in the Federal Register for advisers with less than $1.5 billion in private funds assets under management.
- For the amended Advisers Act compliance rule, 60 days after publication in the Federal Register.

The SEC also provided legacy status with respect to private funds that have commenced operations prior to the compliance dates above. The legacy status provisions apply to contractual agreements governing a private fund that were entered into before the compliance date if the rule would require

the parties to amend the agreements. Specifically, legacy status applies to the prohibitions on:

- preferential redemption rights,
- preferential information rights,
- restrictions on borrowing from a private fund without investor consent, and
- restrictions on charging a private fund for fees and expenses related to certain investigations without investor consent.

The new rules also grandfather some existing practices, meaningfully reducing the implementation burden for funds that have commenced operations prior to the compliance dates. Notwithstanding these changes, the new rules will impose significant compliance burdens and place additional pressure on the relationship between investors and private fund advisers.

If you have questions about the new rules, contact David Lavan or your Dinsmore corporate attorney.

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[1] The new rule defines “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. Any fund that is not illiquid is liquid. In the Adopting release, the SEC noted that most private funds, venture capital funds and real estate funds would be illiquid funds.

[2] However, the SEC did inject some confusion into this point, while indicating that “Whether a pool of assets managed by the adviser is “similar” to the private fund requires a facts and circumstances analysis. A pool of assets with a materially different target return or sector focus, for example, would likely not have substantially similar investment policies, objectives, or strategies to those of the subject private fund, depending on the facts and circumstances. It also noted that, “For example, an adviser’s healthcare-focused private fund may be considered a “similar pool of assets” to the adviser’s technology-focused private fund under the definition.”

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