

The SEC Adopts Final Rules Regarding the Regulation of Private Fund Advisers

On August 23, 2023, by a vote of 3-2, the Securities and Exchange Commission (the “SEC”) adopted new final rules and amendments to existing rules under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) with respect to the regulation of private fund advisers (the “Final Rules”). In the adopting release for the Final Rules (the “Adopting Release”), the SEC noted that the Final Rules are designed to protect investors who directly or indirectly invest in private funds by increasing visibility into certain practices involving compensation schemes, sales practices, and conflicts of interest through disclosure; establishing requirements to address such practices that have the potential to lead to investor harm; and restricting practices that are contrary to the public interest and the protection of investors.¹

Effective Date and Transition Matters. The Final Rules will become effective 60 days following publication in the Federal Register (the “Effective Date”). Compliance with the amended Advisers Act compliance rule will be required from the Effective Date. The Final Rules allow for staggered compliance dates for the other requirements ranging from 12 to 18 months from the Effective Date. Specifically, the Final Rules provide for (i) an 18-month transition period for all private fund advisers for compliance with the Audit Rule and the Quarterly Statement Rule, and (ii) staggered compliance dates with transition periods ranging from 12 to 18 months depending on the size of the adviser for the Adviser-Led Secondaries Rule, the Preferential Treatment Rule, and the Restricted Activities Rule.²

As set forth in Section I below, certain of the Final Rules apply only to registered private fund advisers, while others apply to all private fund advisers (i.e., both registered and unregistered advisers, including exempt reporting advisers).³

¹ Final Rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Aug. 23, 2023), <https://www.sec.gov/files/rules/final/2023/ia-6383.pdf>.

² For advisers with \$1.5 billion or more in private funds assets under management (“larger private fund advisers”), there will be a 12-month transition period and for advisers with less than \$1.5 billion in private funds assets (“smaller private fund advisers”), there will be an 18-month transition period.

³ Notably, in the Adopting Release, the SEC confirmed it will continue to take the position that it does not apply most of the substantive provisions of the Advisers Act with respect to the non-U.S. clients (including private funds) of an SEC-registered offshore adviser. Accordingly, the SEC’s historical approach applies such that none of the Final Rules or related amendments apply with respect to the offshore fund clients of an SEC-registered offshore adviser.

I. High-Level Summary of Final Rules

Final Rules Applicable to Registered Private Fund Advisers:

- Quarterly Statement Rule. Requires registered private fund advisers to provide private fund investors increased transparency with the distribution of a detailed quarterly statement disclosing fund-level information regarding a private fund's performance, the cost of investing in the private fund, certain fees and expenses paid by the private fund and compensation paid to the adviser.
- Audit Rule. Requires registered private fund advisers to cause each private fund client to undergo an audit that meets the requirements of the Custody Rule under the Advisers Act⁴. To the extent an adviser does not control the private fund, the Final Rule requires the adviser to take all reasonable steps to cause the fund to undergo an audit that meets these requirements.
- Adviser-Led Secondaries Rule. Requires registered private fund advisers to obtain a fairness opinion or valuation opinion in connection with an adviser-led secondary transaction⁵ effected between private funds advised by the adviser and/or its related persons.⁶
- Books and Records Rule Amendments. Require registered private fund advisers to retain books and records related to the Quarterly Statement Rule, the Audit Rule, the Adviser-Led Secondaries Rule, the Preferential Treatment Rule and the Restricted Activities Rule.

Final Rules Applicable to All Private Fund Advisers:

- Restricted Activities Rule. All private fund advisers are restricted from engaging in certain activities and practices that are contrary to the public interest and the protection of investors; provided that some activities are allowed with sufficient disclosures to investors, and in some cases, investor consent. For example:
 - 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.
 - An adviser may not reduce the amount of an adviser clawback by the amount of certain taxes, unless the adviser discloses the pre-tax and post-tax amount of the clawback to investors.
 - An adviser may not borrow or receive an extension of credit from a private fund client without disclosure to, and consent from, fund investors.
- Preferential Treatment Rule. All private fund advisers are prohibited from providing preferential terms to investors regarding: (i) redemptions from the fund and (ii) information about portfolio holdings or exposures, in each case if the adviser reasonably expects that it would have a material, negative effect on other investors, except as noted in Section II below. In addition, the Final Rules

⁴ See 17 CFR Rule 206(4)-2. In the Adopting Release, the SEC also noted that it has reopened the comment period for its rulemaking proposal to amend and redesignate the Custody Rule.

⁵ Adviser-led secondary transactions are defined as transactions initiated by the investment adviser or any of 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 and (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. Tender offers will not be captured by the definition if an investor is not faced with the decision between (i) selling all or a portion of its interest and (ii) converting or exchanging all or a portion of its interest.

⁶ The adviser is also required to prepare and distribute to the private fund's investors a summary of any material business relationships the adviser has, or has had within the prior two years, with the independent opinion provider.

prohibit all private fund advisers from providing preferential treatment to investors, unless the material economic terms are disclosed in advance of an investor's investment in the private fund and all preferential terms are disclosed after the investor's investment. Furthermore, there is also an annual notice requirement as described in Section II below.

- Legacy Status. The SEC is only providing legacy status for the prohibitions aspect of the Preferential Treatment Rule and the aspects of the Restricted Activities Rule that require investor consent (i.e., borrowing from a private fund or charging certain investigation fees and expenses as described in Section II below). The legacy status provisions apply to governing agreements that were entered into prior to the compliance date if the applicable rule would require the parties to amend the agreements.

Final Rules Applicable to All Registered Advisers:

- Compliance Rule Amendments. The Final Rules require all registered advisers, including those that do not advise private funds, to document in writing the annual review of their compliance policies and procedures.

II. Notable Modifications

Notably, the Final Rules modify certain portions of the rules that were originally proposed in February 2022 (the "Proposed Rules"). Directly below are certain high-level points describing how the Final Rules differ from the Proposed Rules.

- Waiver or Indemnification Prohibition. The Final Rules do not contain the "waiver or indemnification prohibition," which under the Proposed Rules would have prohibited an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund. In the Adopting Release, the SEC noted that much of the activity that it would have prohibited is already prohibited by an adviser's Federal fiduciary duty and antifraud provisions.
- Adviser Clawback for Taxes. The Proposed Rules would have prohibited an adviser from reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders. The Final Rules do not prohibit advisers from engaging in after-tax adviser clawback reductions if advisers satisfy certain disclosure requirements designed to better inform private fund investors of the impact of after-tax adviser clawback reductions.⁷

⁷ The Final Rules provide that the adviser must distribute a written notice to the investors of such private fund client that sets forth the aggregate dollar amounts of the adviser clawback before and after any reduction for actual, potential, or hypothetical taxes within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.

- Preferential Treatment Rule. The Final Rules have two significant changes from the Proposed Rules:
 - The Final Rules clarify that the preferential redemption right prohibition and preferential information right prohibition regarding portfolio holdings or exposure (i.e., the “prohibitions aspect of the Preferential Treatment Rule”) do not apply if the redemption right or the information, respectively, is offered to all other existing investors in the private fund.⁸ Furthermore, the redemption right prohibition includes an exception if the redemption right is required by law. Notably, the Final Rules provide legacy status under the prohibitions aspect of the Preferential Treatment Rule with respect to private funds that had commenced operations as of the compliance date.⁹
 - The Final Rules limit the Proposed Rules’ requirement to provide *advance* written notice of preferential treatment to only material economic terms¹⁰ (as opposed to all investment terms). In addition, the Final Rules require the adviser to distribute to current investors a written notice of all preferential treatment the adviser or its related persons have provided to other investors in the same private fund (i) for an illiquid fund, as soon as reasonably practicable following the end of the fund’s fundraising period and (ii) for a liquid fund, as soon as reasonably practicable following the investor’s investment in the private fund.¹¹ Notably, the Final Rules do not provide legacy status to private funds with respect to these disclosure portions of the Preferential Treatment Rule.
- Restricted Activities Rule. In a change from the Proposed Rules, the Final Rules will not prohibit the activities and practices described below, as well as the reduction in the amount of a clawback for taxes as described above, so long as the adviser provides certain disclosure, and in some cases, obtains investor consent.
 - An adviser is permitted to charge or allocate to the private fund fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, provided the adviser (i) requests that each investor of the private fund consents to, and (ii) obtains written consent from at least a majority in interest of the private fund’s investors that are not related persons of the adviser for such charge or allocation; however, regardless of any disclosure or consent, 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 or the rules promulgated thereunder.

⁸ The Final Rules similarly prohibit the granting of preferential redemption rights and preferential information rights to investors in any “similar pool of assets.” “Similar pool of assets” is defined as a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940, a company that elects to be regulated as such or a securitized asset fund) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser or its related persons. However, the SEC noted in the Adopting Release that depending on the facts and circumstances, the definition will likely capture vehicles outside of what the private funds industry would view as “substantially similar pool of assets.” As an example, the SEC stated that 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.

⁹ The legacy status provisions apply to governing agreements that were entered into prior to the compliance date if the Final Rule would require the parties to amend such an agreement (i.e., contractual agreements that govern the fund, which include, but are not limited to, the private fund’s operating or organizational agreements (e.g., the limited partnership agreement, the limited liability company agreement, articles of association, or by-laws), the subscription agreements, and side letters). The SEC noted that to prevent advisers from abusing this provision, legacy status applies only to such agreements with respect to private funds that had commenced operations as of the applicable compliance date.

¹⁰ Material economic terms include, but are not limited to, the cost of investing, liquidity rights, fee breaks, and co-investment rights.

¹¹ In addition, advisers are required to provide to current investors annual disclosure of all preferential treatment provided by the adviser or its related persons since the last notice.

- An adviser is permitted to charge or allocate to the private fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, of the adviser or its related persons, provided the adviser distributes a written notice of any such fees or expenses, and the dollar amount thereof, to the investors of such private fund client in writing within 45 days after the end of the fiscal quarter in which the charge occurs.
- An adviser is permitted to charge or allocate fees and expenses to the private fund 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, provided (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 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.
- An adviser is permitted to borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client, provided the adviser: (i) distributes to each investor a written description of the material terms of, and requests each investor to consent to, such borrowing, loan, or extension of credit; and (ii) obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser.
- The Final Rules do not implement a prohibition on fees for unperformed services, as the SEC noted that this activity is contrary to an adviser's obligations to its clients under the adviser's Federal fiduciary duty.
- Audit Rule.
 - In a change from the Proposed Rules, the SEC is requiring the audit to comply with the audit provision under the Custody Rule. While the SEC noted that it continues to believe that it is important for audited financial statements to be prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), the Final Rules clarify that audited financial statements may be prepared in accordance with some other comprehensive body of accounting standards similar to U.S. GAAP if the differences are reconciled to U.S. GAAP.¹²
 - Furthermore, in the Proposed Rules the SEC proposed that the audited financial statements be distributed "promptly" after the completion of the audit. However, in the Final Rules, the SEC noted that it believes that a 120-day time period is generally appropriate to allow the financial statements of a fund to be audited while also balancing the needs of investors to receive timely information.
 - In a change from the Proposed Rules, the Final Rules will not require that auditors notify the SEC (i) promptly upon issuing an audit report to the private fund that contains a modified opinion and (ii) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.

¹² The SEC specifically refers to the 2003 Custody Rule release in making this clarification.

- **Quarterly Statement Rule.** In a change from the Proposed Rules, the Final Rules provide that: (i) advisers to illiquid funds are required to calculate performance information with and without the impact of subscription facilities, rather than only without; (ii) the definition of illiquid fund will be based primarily on withdrawal and redemption capability; (iii) instead of requiring advisers to present liquid fund performance since inception, such performance is limited to a 10-year lookback; and (iv) advisers receive additional time for (A) delivery of fourth quarter statements and (B) all statements for funds of funds.¹³
- **Adviser-Led Secondaries Rule.** In a change from the Proposed Rules, advisers may obtain a fairness opinion or a valuation opinion under the Final Rules. In addition, the Final Rules require that the adviser distribute both the opinion and summary of material business relationships to private fund investors prior to the due date of the election form for the transaction instead of prior to the closing of the transaction.
- **Securitized Asset Funds.** In the Final Rules, the Quarterly Statement Rule, the Audit Rule, the Adviser-Led Secondaries Rule, the Restricted Activities Rule, and the Preferential Treatment Rule do not apply to securitized asset fund clients.

If you have any questions regarding the matters covered in this memo, please contact any of the partners and counsel listed below or your primary attorney in Seward & Kissel's Investment Management Group.

Daniel Bresler bresler@sewkis.com (212) 574-1203	Debra Franzese franzese@sewkis.com (212) 574-135	Robert M. Kurucz kurucz@sewkis.com (202) 661-7195
Nicholas R. Miller millern@sewkis.com (212) 574-1359	Paul M. Miller millerp@sewkis.com (202) 737-8833	Joseph M. Morrissey morrissey@sewkis.com (212) 574-1245
David R. Mulle mulle@sewkis.com (212) 574-1452	Steven B. Nadel nadel@sewkis.com (212) 574-1231	Kevin Neubauer neubauer@sewkis.com (212) 574-1355
Patricia A. Poglinco poglinco@sewkis.com (212) 574-1247	Christopher Riccardi riccardi@sewkis.com (212) 574-1535	Robert B. Van Grover vangrover@sewkis.com (212) 574-1205
Daniel G. Viola viola@sewkis.com (212) 574-1457	Alexandra Alberstadt alberstadt@sewkis.com (212) 574-1217	Jay Barody barody@sewkis.com (212) 574-1347
Kevin Cassidy cassidy@sewkis.com (212) 574-1542	Lancelot A. King king@sewkis.com (202) 661-7196	

¹³ 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.