WINSTON & STRAWN LLP

CLIENT ALERT

Summary of the SEC's Private Fund Adviser Rules

AUGUST 30, 2023

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I. Introduction

On August 23, 2023, the Securities and Exchange Commission (SEC) adopted[1] new rules and amendments to existing rules under the Investment Advisers Act of 1940, as amended (Advisers Act),[2] which impact SEC-registered private fund advisers, as well as most private fund advisers that are not SEC-registered (including exempt reporting advisers and foreign private advisers) (the Release). Generally, a "private fund" is an investment vehicle that is not required to register as an investment company because it raises capital from investors in a private offering and either (i) has 100 or fewer investors or (ii) all of its investors are qualified purchasers.[3]

The new rules do not apply to advisers with respect to any "securitized asset funds"[4] they may advise. Generally, none of the new rules or amendments to existing rules apply to advisers with a principal office and place of business outside of the United States with respect to their non-U.S. private fund clients (regardless of whether they have U.S. investors). Nevertheless, all SEC-registered advisers are subject to the amendments to the Compliance Procedures and Practices rule, regardless of whether they only manage securitized assets funds or are offshore. Also, certain of the new rules do not apply to existing contractual agreements governing private funds (e.g., existing limited partnership agreements and side letters). For purposes of this Client Alert, references to "private fund advisers," "SEC-registered private fund advisers," and "SEC-registered advisers" do not include advisers subject to the exceptions listed in this paragraph.[5]

The SEC promulgated five new rules and amended two existing rules. The new rules are as follows:

SEC RULE	RULE NAME	APPLICABLE TO
211(h)(2)-1	Restricted Activities	Private Fund Advisers

		(Some provisions do not apply to existing fund governing documents and contractual agreements)
211(h)(2)-3	Preferential Treatment	Private Fund Advisers (Some provisions do not apply to existing fund governing documents and contractual agreements)
206(4)-10	Private Fund Adviser Audits	SEC-Registered Private Fund Advisers
211(h)(1)-2	Private Fund Quarterly Statements	SEC-Registered Private Fund Advisers
211(h)(2)-2	Adviser-Led Secondaries	SEC-Registered Private Fund Advisers

The amended rules are as follows:

SEC RULE	RULE NAME	APPLICABLE TO
204-2	Books and Records	SEC-Registered Private Fund Advisers
206(4)-7(b)	Compliance Procedures and Practices	*All* Registered Advisers

This Client Alert summarizes the new obligations and the prohibitions that apply to private fund advisers under the new rules and amendments.

II. Requirements for Private Fund Advisers Regardless of SEC Registration Status

A. RESTRICTED ACTIVITIES RULE – DISCLOSURE REQUIRED

- *Regulatory Fees and Expenses.* Private fund advisers are prohibited from charging or allocating to a private fund the adviser's compliance, regulatory, and examination fees or expenses, unless such fees and expenses and their dollar amounts are disclosed in writing to all fund investors within 45 days after the end of the fiscal quarter in which such charges occur.[6]

- *Clawback*. Private fund advisers are prohibited from reducing clawback obligations (i.e., any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation pursuant to a private fund client's governing documents) by actual, potential, or hypothetical taxes, unless the pre-tax and post-tax amount of the clawback is disclosed in writing to investors within 45 days after the end of the fiscal quarter in which the clawback occurred.
- *Charging Fees or Allocating Expenses on a Non-Pro Rata Basis*. Private fund advisers are prohibited from charging or allocating fees and expenses related to actual or potential portfolio investments on a non-pro rata basis with the adviser's other private funds, other clients, and the adviser or its related persons, unless (i) such non-pro rata basis is fair and equitable and (ii) prior to charging or allocating such fees or expenses to a private fund, 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.

B. RESTRICTED ACTIVITIES RULE – DISCLOSURE AND CONSENT REQUIRED

- *Borrowing from Private Funds.* Private fund advisers are prohibited from borrowing money, securities, or other private fund assets, or receiving loans or extensions of credit, from a private fund, unless the adviser: (i) provides 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.
- *Investigation Fees and Expenses.* Private fund advisers are prohibited from charging or allocating to a private fund fees and expenses related to an investigation of the adviser or its related persons by any governmental or regulatory authority unless the adviser obtains the written consent of at least the majority in interest of fund investors that are not related persons of the adviser.
    - *However, regardless of any disclosure or consent, advisers are prohibited from charging or allocating such fees and expenses for an investigation that results in a court or governmental authority imposing a sanction for a violation of the Advisers Act or the rules promulgated thereunder*.
- *Existing Funds.* The new rules regarding Borrowing from Private Funds and Investigation Fees and Expenses do not apply to existing written contractual agreements (e.g., side letters and organizational documents) governing a private fund that has commenced operations as of the compliance date and that were entered into prior to the compliance date if the new rules would require the parties to amend such governing agreements.

C. PREFERENTIAL TREATMENT RULE – PROHIBITED ACTIVITIES

- *Redemption Rights*. Private fund advisers are prohibited from offering preferential redemption rights to any private fund investor that will have a material, negative effect[7] on other investors in that fund or in a similar pool of assets[8] unless such rights are (i) offered to all current and future fund investors, or (ii) required by applicable law, rule, regulation, or order of certain governmental authorities.
- *Information Rights*. Private fund advisers are prohibited from offering preferential information rights regarding portfolio holdings or exposures of the fund or a similar pool of assets that will have a material, negative effect on other investors in that private fund or in a similar pool of assets unless such information is offered to all fund investors.
- *Existing Funds.* The new rules regarding Redemption Rights and Information Rights do not apply to existing written contractual agreements (e.g., side letters and organizational documents) governing a private fund that has commenced operations as of the compliance date and that were entered into prior to the compliance date if the new rules would require the parties to amend such governing agreements.

D. PREFERENTIAL TREATMENT RULE – DISCLOSURE REQUIRED

Private fund advisers are prohibited from providing, directly or indirectly through their associated persons, any preferential treatment (e.g., through a side letter) to any investor in a private fund unless the adviser provides the following written notices:

- *Written Notice to Prospective Investors*. The adviser must provide each prospective investor to the fund with a written notice providing specific information about any preferential material economic terms that the adviser or its related persons provide to other fund investors.
- *Written Notice to Current Investors*. The adviser must distribute to current fund investors a written disclosure of all preferential treatment provided to other fund investors. For "illiquid funds"[9] (e.g., private equity and venture capital funds), such disclosure must be made as soon as reasonably practicable following the end of the fund's fundraising period. For "liquid funds" [10] (e.g., hedge funds and commingled "long-only" funds), such disclosure must be made as soon as reasonably practicable following the investor's investment in the private fund.
- *Annual Notice to Current Investors*. At least annually, the adviser must distribute to current fund investors a written notice that provides specific information about any preferential treatment provided to other fund investors since the last written notice provided by the adviser.

III. Additional Requirements for SEC-Registered Private Fund Advisers

A. QUARTERLY STATEMENT RULE

- *Timing*. SEC-registered private fund advisers must distribute quarterly statements to private fund investors within 45 days after the end of each of the first three fiscal quarters of each fiscal year of the fund and 90 days after the end of each fiscal year of the fund. For funds of funds,[11] these deadlines are 75 days and 120 days respectively.
- *Fund Table*. The quarterly statement must contain the following detailed information, both before and after any offsets, rebates, or waivers:
  - All compensation, fees and other amounts allocated or paid to the adviser during the quarter.
  - All fees and expenses allocated to or paid by the private fund during the quarter, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses.
  - The amount of any offsets or rebates carried forward during the quarter to subsequent periods to reduce future payments or allocations to the adviser or its related persons.
- *Portfolio Investment Table*. The quarterly statement must contain a table detailing the fees or other compensation paid or allocated to the adviser or its related persons from a portfolio investment both before and after the application of any offsets, rebates, or waivers.
- *Calculations and Cross-References*. The quarterly statement must disclose the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated, including cross references to the applicable sections of the private fund's organizational and offering documents.
- *Performance*. Beginning with the initial quarterly report, the quarterly statement must contain detailed performance information, which varies depending on whether the private fund is liquid or illiquid.
- *Format and Content*. The quarterly statement must be written in clear, concise, plain English, and in a format that facilitates review from one quarterly statement to the next.

B. PRIVATE FUND AUDIT RULE

SEC-registered private fund advisers are required to obtain audited financial statements, prepared in accordance with the requirements of the Custody Rule (Rule 206(4)-2(b)(4)), of the private funds they manage on an annual basis and upon the liquidation of a private fund. The audit must be performed by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board in accordance with US GAAP (or the equivalent for non-U.S. funds) and the auditor is required to notify the SEC of certain events (e.g., termination of the auditor's engagement).

C. ADVISER-LED SECONDARIES RULE

SEC-registered private fund advisers that are conducting an "adviser-led secondary transaction"[12] are required (i) to obtain and distribute to investors in the private fund either a fairness opinion or a valuation opinion from an independent opinion provider, and (ii) to distribute to fund investors a written summary of any material business relationships the adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider. Such materials must be distributed to private fund investors prior to the due date of the election form for the secondary transaction.[13]

D. BOOKS AND RECORDS RULE AMENDMENTS

The SEC amended the books and records rule (Rule 204-2) to require SEC-registered private fund advisers to keep records relating to the new rules (e.g., records with respect to quarterly statements, annual audits, disclosures regarding restricted activities, fairness or valuation opinions, and disclosures regarding preferential treatment).

IV. Requirements for SEC-Registered Advisers – Compliance Rule Amendments

The SEC amended the compliance procedures and practices rule (Rule 206(4)-7) to require all SEC-registered advisers, including SEC-registered advisers to securitized asset funds (not only SEC-registered private fund advisers) to, at least annually, review and document in writing the adequacy and the effectiveness of their policies and procedures.

V. Transition Periods (Following Publication in the Federal Register)

As of the date of this Client Alert, the new rules and amendments have not been published in the Federal Register. Once published in the Federal Register, the new rules and amendments will become effective in accordance with the following transition periods:

RULE	LARGER ADVISERS PRIVATE FUND AUM $1.5 BILLION OR MORE	SMALLER ADVISERS PRIVATE FUND AUM LESS THAN $1.5 BILLION
Audit Rule Quarterly Statement Rule	18 Months after publication. (Compliance date 3/1/2025 at the earliest)[1]	18 Months after publication. (Compliance date 3/1/2025 at the earliest)
Adviser-Led Secondaries Rule Preferential Treatment Rule Restricted Activities Rule	12 Months after publication. (Compliance date 8/31/2024 at the earliest)	18 Months after publication. (Compliance date 3/1/2025 at the earliest)

Amended Compliance Rule	60 Days after publication. (Compliance date 10/30/2023 at the earliest)	60 Days after publication. (Compliance date 10/30/2023 at the earliest)

VI. Conclusion

These new rules and amendments can have a material impact on private fund advisers, regardless of whether they are SEC-registered, and could significantly increase the compliance costs for private fund advisers. Moreover, these rules and amendments change long-standing, negotiated market practices applicable to private fund advisers.

We are available at your convenience to discuss the matters addressed in the Release, including assisting you with reviews of your side letters and other agreements governing your private funds, compliance policies and procedures, as well as other ways the new rules and amendments may affect your business.

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[1] Please see our Client Alert regarding the proposed release for these rules and amendments at https://www.winston.com/en/insights-news/the-secs-proposed-rules-create-new-obligations-as-well-as-prohibitions-for-private-fund-advisers. The SEC's proposed rules and amendments were issued pursuant to SEC Release No. IA-5955 and can be found at https://www.sec.gov/files/rules/proposed/2022/ia-5955.pdf.

[2] SEC Release No. IA-6383. The new rules and amendments can be found at https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.

[3] Section 202(a)(29) of the Advisers Act defines the term "private fund" as an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3) ("Investment Company Act"), but for section 3(c)(1) or 3(c)(7) of the Investment Company Act.

[4] "Securitized asset fund" means any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders.

[5] The new rules contain many defined terms, only some of which are included in the footnotes to this Client Alert.

[6] See Section II.B – *Investigation Fees and Expenses* below for a discussion of the prohibition on charging or allocating to private funds expenses related to investigations by governmental or regulatory authorities.

[7] The "material, negative effect on other investors" standard is based on the reasonable expectation of the adviser. The SEC commented that this standard does not require advisers to make predictions about how others will react, but rather requires advisers to form only a reasonable expectation based on the facts and circumstances at the time a decision is made.

[8] "Similar pool of assets" is defined in Rule 211(h)(1)-1 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 investment adviser or its related persons."

[9] "Illiquid fund" is defined in Rule 211(h)(1)-1 as "a private fund that: (1) Is not required to redeem interests upon an investor's request; and (2) Has limited opportunities, if any, for investors to withdraw before termination of the fund."

[10] "Liquid fund" is defined as "a private fund that is not an illiquid fund."

[11] Although "fund of funds" is not defined in the new rules, the SEC referenced the Custody Rule FAQ at Question VI.7 (available at https://www.sec.gov/divisions/investment/custody_faq_030510), which defines a fund of funds as "a pooled investment vehicle that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person of the pool, its general partner, or its adviser."

[12] "Adviser-led secondary transaction" is defined as "any transaction initiated by the investment adviser or any of its related persons that offers private fund investors the choice between: (1) Selling all or a portion of their interests in the private fund; and (2) 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."

[13] "Election form" is defined as "a written solicitation distributed by, or on behalf of, the adviser or any related person requesting private fund investors to make a binding election to participate in an adviser-led secondary transaction."

[14] Earliest compliance dates calculated as if publication occurred on 9/1/2023.

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