SEC Adopts New Rules to Better Protect Institutional Investors in Private Funds

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On August 23, 2023, the U.S. Securities and Exchange Commission (SEC) voted 3-2 to approve 660 pages of new rules and amendments modifying the Investment Advisers Act of 1940 (Advisers Act). The new rules represent some of the most significant reforms in regulating private fund advisers since the Advisers Act was first enacted (Final Rules). The SEC received extensive comment letters from industry groups, private fund advisers and institutional investors after making the proposed rules (Proposed Rules) public nearly a year and a half ago.

The GP community especially pushed back against the Proposed Rules arguing that fund terms should not be dictated by the SEC but should continue to be negotiated between "sophisticated" institutional investors and private fund advisers, and that the increased regulations with respect to audits, disclosures and reporting would increase costs and limit investment options for institutional investors.

The Final Rules, although still opposed by many GPs, have been watered down and are not as expansive as the GPs had feared. The Final Rules address many of the issues that the LPs have complained to the SEC about over the years while still recognizing the important role that private fund investments play today in the investment portfolios of most institutional investors. With the adoption of the Final Rules, the SEC attempts to better protect LP interests by encouraging accountability and transparency while at the same time fostering public trust and interest in alternative investments.

The Final Rules

The following three rules apply to *registered* Private Fund Advisers:

1. **Quarterly Statement Rule**: Registered private fund advisers must provide a quarterly statement to investors that includes fund-level details such as performance, investment costs, fees, expenses and compensation paid to the advisers.

2. **Private Fund Audit Rule**: Registered private fund advisers must obtain an annual financial statement audit of the funds they directly or indirectly advise. The audits must meet the audit provisions set forth in the Advisers Act's custody rule (rule 206(4)-2)).
3. **Adviser-Led Secondaries Rule**: Registered private fund advisers that offer investors the option of selling some or all of their interests and converting those interests for interests in another vehicle must obtain a fairness or valuation opinion and provide a summary of any material business relationships the advisers have or have had with the independent opinion provider within the prior two years.

The following two rules apply to *all* Private Fund Advisers:

1. **Restricted Activities Rule**: Private fund advisers cannot engage in the following activities:
    1. Without disclosure to, and consent from the investors, private fund advisers cannot 1) charge the fund with fees or expenses for a governmental or regulatory investigation of the adviser; or 2) borrow from the fund.
    2. Without certain disclosures to the investors, private fund advisers cannot 1) charge the fund any compliance, examination or regulatory fees; 2) reduce the amount of an adviser clawback by actual or hypothetical taxes (disclosures must include the pre-tax and post-tax amounts); or 3) charge the fund fees or expense related to portfolio investment on a non-pro rata basis (unless the allocation is fair and equitable and the adviser so explains).
    3. Regardless of disclosure or consent, private fund advisers cannot charge the fund fees or expenses related to an investigation that results in or has resulted in the imposition of sanctions for a violation of the Advisers Act.
2. **Preferential Treatment Rule:** Private fund advisers cannot provide preferential terms to investors that have a material negative effect on other investors regarding 1) certain redemptions from the fund, unless the ability to redeem is required by applicable law or such redemption rights are offered to all the other investors; 2) information about portfolio holdings and exposures, unless such information is offered to all other investors; or 3) preferential treatment (such as with respect to side letters), unless material economic terms (although not all investment terms) are disclosed before an investment is made in the fund and all terms are disclosed after the investment in the fund.

It is important to note that despite the concerns expressed by the GP community that the Proposed Rules would alter the standard of care in investment documentation, the Final Rules ultimately do not impose such limitations on indemnification, exculpation, reimbursement or limitation of liability. Similarly, the SEC did not adopt the prohibition on charging for services not performed as set forth in the Proposed Rules, stating that such a practice is already inconsistent with the private fund adviser's fiduciary duties under the Advisers Act.

Legacy Status

The SEC will grant legacy status for the prohibitions aspect of the Preferential Treatment Rule (which prohibits advisers from providing certain preferential redemption rights and information about portfolio holdings). The SEC will also grant legacy status for the investor consent aspect of the Restricted Activities Rule (which prohibits advisers from borrowing from a fund and charging for certain fees and expenses).

Compliance Deadlines

The Final Rules will be in effect 60 days after they are published in the Federal Register. Private fund advisers will then have varying transition periods depending on the rule to be in full compliance:

1. For the Quarterly Statement Rule and Private Fund Audit Rule – 18 months.
2. For the Adviser-Led Secondaries Rule, the Restricted Activities Rule and the Preferential Treatment Rule – 12 months for advisers with $1.5 billion or more AUM, and 18 months for advisers with less than $1.5 billion AUM.

Looking Forward

During the comment period, the GPs pushed-back and threatened legal challenges to the Final Rules if approved. Although the SEC has scaled back some of the most controversial aspects of the Proposed Rules, we believe that the GP community may well commence litigation to prevent the implementation of the Final Rules (if not on substance, then at least on procedural grounds with respect to the SEC's authority to approve the Final Rules). We remain hopeful that after the dust has settled, many of the Final Rules will remain in effect and offer better protections for investors than before. Since the Final Rules have only recently been approved, it's still too early to tell how the Final Rules will impact fund terms and negotiations with the GPs.

As an LP-only law firm that works on behalf of institutional investors, many of whom are fiduciaries of trust funds that they are investing, we remain hopeful that despite the scaled back approach to the Final Rules, the increased oversight of private fund advisers by the SEC will nonetheless guide GPs to implement better practices and overall improve fund terms. This will permit institutional investors to invest in private funds with stronger protections of those investments. We look forward to keeping you apprised of developments arising from the implementation of the Final Rules.