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SPLIT SEC ADOPTS NEW AND AMENDED RULES OVERHAULING PRIVATE FUND INDUSTRY

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On August 23, 2023, the US Securities and Exchange Commission (SEC) voted 3-2 to adopt new and amended rules under the Investment Advisers Act of 1940, as amended (Advisers Act) that will impose additional requirements on registered investment advisers and will restrict certain activities for all advisers to private funds, regardless of SEC registration status[1] (Final Rules).

The SEC approved the Final Rules despite strong industry objection and dissents from Commissioners Hester Peirce and Mark Uyeda. In contrast, Chairman Gary Gensler indicated that he views the Final Rules as enhancing advisers' transparency and integrity, as well as promoting greater competition and efficiency.

OVERVIEW OF THE FINAL RULES

The Final Rules consist of five new rules (six, if you count the rule in which the Final Rules' definitions reside) and amendments to two existing rules under the Advisers Act. Any one of these rulemakings would be significant on its own; the aggregation represents the most substantial change to the regulation of private funds since the Dodd-Frank Act of 2010 in the wake of the Great Recession. The Final Rules have differing timelines for effectiveness after publication of the Adopting Release in the *Federal Register*, which are summarized below under "Compliance Dates."

Although the Final Rules provide somewhat more flexibility than the proposed rules (Proposal) in certain circumstances, they nonetheless are a seismic shift in the regulatory landscape for private fund advisers. Certain material changes from the Proposal include (1) an update to the timing of quarterly statements; (2) switching "prohibited activities" to "restricted activities," which will be permitted if certain disclosure and/or consent conditions are met (among other things); (3) certain exceptions to the prohibition on preferential rights; and (4) "legacy status" that provides exceptions to some of the requirements for certain existing funds. The SEC also chose not to adopt the Proposal's prohibitions on both charging fees for unperformed services and limiting adviser liability. However, the SEC indicated that these concepts and limitations still apply to advisers, notwithstanding they are not explicitly included in the Final Rules.

In addition, as adopted, none of the Final Rules (other than the annual compliance program rule described below) will apply to securitized asset funds, such as collateralized loan obligations (CLOs) or other types of asset-backed securities funds.

QUARTERLY STATEMENT RULE (NEW RULE 211(H)(1)-2)

Under the SEC's new rule on quarterly statements (Quarterly Statement Rule), unless a statement is otherwise prepared and distributed by another person, an SEC-registered adviser that advises one or more private funds must prepare a quarterly statement for each private fund that it advises (directly or indirectly) if such fund has had at least two full fiscal quarters of operating results.

[1] Under the Advisers Act, a "private fund" is an issuer that would be an investment company, as defined in the US Investment Company Act of 1940, as amended (Investment Company Act), but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

Under the Quarterly Statement Rule, an adviser will be required to distribute a quarterly statement to investors within 45 days after the end of each of the first three fiscal quarters of each fiscal year, and within 90 days after the end of the private fund's fiscal year. In the case of a private fund that is a fund-of-funds, advisers will have 75 days after the end of each of the first three fiscal quarters and within 120 days after the end of the fund-of-fund's fiscal year.

Electronic delivery of quarterly statements is generally permitted but must be in accordance with the SEC's guidance regarding electronic delivery, meaning that investors will be required to receive notice of, and have access to, electronic quarterly statements within the applicable 45 to 120 day period.

The content required to be disclosed in a quarterly statement will depend on whether the private fund is a liquid fund or an illiquid fund, as determined by the adviser. "Liquid" or "illiquid" status of a private fund is determined primarily on withdrawal rights.[2] In general, most traditional private equity and venture capital funds will likely be characterized as "illiquid" funds and most traditional hedge funds that offer investors monthly or quarterly liquidity will likely be characterized as "liquid" funds, but there is a substantial universe of private fund products that fall somewhere in the middle and will have to analyze their status based on the limited guidance available from the SEC in the Final Rules and the Adopting Release.

A quarterly statement must include the following:

- A "Fund Table" with extensive calculation of fees and expenses paid by, or allocated to, the private fund, on a line-by-line basis, both before and after the application of any offsets, rebates, or waivers. These Fund Table fees and expenses must include a "detailed accounting" of compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons (including management fees, advisory fees, sub-advisory fees, similar fees or payments, and performance fees). Funds must also disclose organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses, as well as the amount of any offsets or rebates carried forward during the reporting period.
- A "Portfolio Investment Table" with fees and compensation paid by, or allocated to, the adviser and its related persons by each portfolio investment, with separate line items for each category of allocation or payment, calculated before and after the application of any offsets, rebates, or waivers.
- Prominent disclosure as to the manner of calculation, including cross-references to the applicable sections of a private fund's operative documents.
- Extensive performance data, the substance of which will depend on whether the fund is a liquid fund or an illiquid fund. Liquid funds will be required to disclose (1) annual net total returns for each of the last 10 years (or since inception, if shorter), (2) average annual net total returns over one, five, and 10-year periods, and (3) cumulative net total returns for the current fiscal year and most recent fiscal quarter. Illiquid funds will be required to disclose Internal Rate of Return (IRR) and Multiple of Invested Capital

[2] The Final Rules define "illiquid fund" more narrowly than the Proposal 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. Although the Final Rules do not require an adviser to revisit its determination of a fund's status as liquid or illiquid, the SEC indicated that advisers should generally consider whether they are providing accurate information to investors and whether they need to revisit such determination in response to any future changes to the fund.

(MOIC) on both gross and net bases as of the end of the reporting quarter (or most recent practicable date if quarterly numbers are unavailable), computed with and without the impact of any fund-level subscription facilities. Illiquid funds will also be required to separately report gross IRR and MOIC for the realized and unrealized portions of the fund's portfolio as of the end of the reporting quarter (or most recent practicable date if quarterly numbers are unavailable). Finally, illiquid funds will be required to report a statement of the fund's contributions and distributions.

The Quarterly Statement Rule also requires that reports use "clear, concise, plain English" and present information in a format that facilitates review across statements. Although such requirements seem objective and non-controversial, what is "clear" and "concise" to one person may not be "clear" and "concise" to everyone. The Final Rules permit an adviser to prepare consolidated quarterly statements for similar pools of assets, as long as it would not be misleading to the private funds' investors, which may be useful for private fund complexes that have high levels of repeat investors across fund offerings.

Other than the timing distinction noted earlier, there is no carveout for the level of information that a private fund-of-funds will be required to report, although the Adopting Release recognizes that certain information could be difficult to acquire or ascertain, such as portfolio level information about compensation. In such case, the SEC suggested a good faith determination and diligence standard, but also indicated that advisers "will need to consider contractual or other types of arrangements with their underlying investments to attain this information in a timely manner."

Unlike the Proposal, the SEC did not adopt the requirement that the Portfolio Investment Table include a fund's ownership percentage of each covered portfolio investment.

Takeaways/Impressions

Although most private fund advisers already provide some form of reporting or statements to investors, such reports have not previously been required, and therefore there was flexibility in terms of content and format, which is now much more prescribed. Even those private fund managers with sophisticated systems in place for investor reporting will have to carefully analyze and recalibrate those existing frameworks to ensure that they align with the prescriptive requirements of the Final Rules, and also make sure that they have appropriate delivery mechanisms in place to push quarterly statements out to investors.

Private fund managers that currently advise or sub-advise registered funds will find the performance reporting requirements of liquid funds to be very familiar: they are virtually identical to what has long been required for mutual funds, ETFs, and other registered funds. Illiquid fund managers are faced with the prospect of quarterly calculating more than a dozen complex metrics (after taking into account different required variables), each of which will have a complicated set of underlying assumptions and calculation methodologies. For smaller advisers, the investment in personnel and systems to be able to make and distribute these calculations on a quarterly basis, and subject those calculations to the oversight of compliance, could be burdensome.

PRIVATE FUND AUDIT RULE (NEW RULE 206(4)-10)

The new rule governing private fund audits (Audit Rule) will require an SEC-registered adviser that advises one or more private funds to obtain an audited financial statement of each private fund it advises, directly or indirectly, in accordance with the audit provisions (and related requirements for delivery of audited financial statements) set forth in Rule 206(4)-2 under the Advisers Act (Custody Rule). In particular, the Audit Rule, consistent with the Custody Rule, requires (1) the audit to be performed by

an independent public accountant with oversight by the Public Company Accounting Oversight Board (PCAOB); (2) the audit to meet the definition of "audit" under Regulation S-X; (3) audited financial statements to be prepared in accordance with GAAP;[3] and (4) the audit to be delivered annually within 120 days of the private fund's fiscal year end, and "promptly" upon liquidation.

The Audit Rule also imposes, as proposed, a separate standard for funds and advisers that are not in a control relationship with one another (i.e., a third-party adviser to an unaffiliated fund). Such third-party advisers must take "all reasonable steps" to cause the private fund to undergo an audit that meets the Custody Rule requirements. Where such third-party adviser does not take all reasonable steps, it will be prohibited from providing investment advice (directly or indirectly) to the fund.

Takeaways/Impressions

The Audit Rule effectively mandates that private advisers rely on the "audit exception" under the Custody Rule.[4] Furthermore, by cross-referencing the Custody Rule provisions, including in the context of applicable definitions, it remains to be seen how the Audit Rule will be affected by any changes to the Custody Rule that the SEC recently proposed and is considering.[5] Although it is rather unlikely that there are many actual examples in the marketplace, it will be interesting to see what market consensus forms, if any, around what "all reasonable steps" would be with respect to a third-party adviser making its advised private fund obtain an audit. Furthermore, where a private fund refuses to get an audit despite its third-party adviser taking all reasonable steps, it is unclear how such adviser could cease providing investment advice to the fund without potentially harming the fund and its investors.

ADVISER-LED SECONDARIES RULE (NEW RULE 211(H)(2)-2)

Under the new rule regarding adviser-led secondary transactions (Adviser-Led Secondaries Rule), an SEC-registered adviser that advises one or more private funds will be required to provide to investors, prior to the due date of the applicable investor election form for such an adviser-led secondary transaction, (1) a fairness opinion or a valuation opinion from an independent opinion provider and (2) a summary of any material business relationships the adviser or any of its related persons has, or has had, with the independent opinion provider, during the two-year period immediately prior to the issuance of such opinion. In the Proposal, there was no option for a valuation opinion in lieu of a fairness opinion, so the

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[3] According to the Adopting Release, this could either be US GAAP or "some other comprehensive body of accounting standards if the information is substantially similar to financial statements prepared in accordance with US GAAP and contain a footnote reconciling any material differences."

[4] Currently, the Custody Rule requires a private fund manager in a control relationship with a private fund annually to undergo a surprise examination by an independent auditor, but the Custody Rule provides an exemption from the annual surprise examination requirement if the private fund annually prepares and distributes audited financial statements. Although the majority of private fund managers already facilitate the preparation and delivery of audited financials to take advantage of this exemption (and in response to commercial pressures and market practices from investors), the Audit Rule effectively removes any optionality from private fund managers.

[5] The SEC's proposal, Safeguarding Advisory Client Assets, Investment Advisers Act Release No. 6240 (Feb. 15, 2023) (Safeguarding Proposal), remains under consideration by the SEC. The comment period for the Safeguarding Proposal was reopened on August 23, 2023, at the same meeting at which the Final Rules were adopted.

final version of the Adviser-Led Secondaries Rule does provide some additional flexibility than what was proposed.

The SEC defined "adviser-led secondary transaction" in Rule 211(h)(1)-1 (which sets forth the various defined terms of the Final Rules) 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.

The definition in the Final Rules permits a "choice between" the options of selling "and" converting/exchanging fund interests, compared to the language in the Proposal, which referred to a "choice to" sell "or" convert/exchange fund interests. Although the definition, on its face, is very similar to the Proposal, the SEC indicated in the Adopting Release that this modified definition is intended generally to exclude tender offers from such definition if investors in such a tender offer are not being offered a choice between selling and converting/exchanging their interests. Continuation funds would typically be captured under the adopted definition.

Takeaways/Impressions

Many, but not all, adviser-led secondary transactions already involve fairness opinions or valuation opinions, so the Adviser-Led Secondaries Rule is largely a codification of prevailing market practices. However, fairness opinions and valuation opinions are sometimes not provided when there is an auction process for an adviser-led secondaries deal, and the Adviser-Led Secondaries Rule would now mandate them in that context.

Regarding the disclosure of material business relationships with the independent opinion provider, the SEC explains that such business relationships may give the appearance of, or may result in, a biased opinion, particularly if they are not disclosed to investors. This commentary is consistent with the SEC's increased scrutiny in recent years on conflicts of interest and the need for robust disclosure to investors. However, given the breadth of the definition of "related person" in Rule 211(h)(1)-1, which picks up any person under common control with the adviser or any person directly—or indirectly—controlled by the adviser, conducting an analysis of material business relationships between an independent opinion provider and all related persons of an adviser could prove to be a significant undertaking, particularly for a larger adviser with multiple advisory affiliates and with complex relationships across a large universe of portfolio companies. Not only will an adviser be required to map out its web of "related persons" for this exercise, but it will also need to evaluate whether any such related persons conduct business with the independent opinion provider. Where independent opinion providers offer multiple lines of business, that will present an additional layer of complexity for complying with this element of the Adviser-Led Secondaries Rule.

RESTRICTED ACTIVITIES RULE (NEW RULE 211(H)(2)-1)

In a significant change to private fund adviser regulation, under the new rule on private fund adviser restricted activities (Restricted Activities Rule), **all advisers to private funds**—regardless of whether they are registered with the SEC, relying on an exemption from registration (including, but not limited to, exempt reporting advisers), registered with one or more state securities regulators, or based in the US but entirely unregistered—will be restricted from engaging in certain practices, unless they meet prescribed disclosure requirements, and in some cases, receive investor consent, among other conditions. Although the adopted version of the Restricted Activities Rule is more commercial on its face than the Proposal, in that it does not outright prohibit the enumerated activities, as a practical matter, in many

cases, the conditions of the final Restricted Activities Rule will effectively yield the same result as outright prohibitions.

The Restricted Activities Rule will restrict private fund advisers from the following:

- Charging or allocating to a private fund any fees or expenses associated with an investigation of the adviser or its related persons by governmental or regulatory authorities, unless the adviser discloses and receives investor consent for these practices. Regardless, advisers will be outright prohibited from charging fees or expenses to a fund related to an investigation that results in a court or government authority imposing sanctions on the adviser for a violation of the Advisers Act or the rules thereunder.
- Charging the private fund any regulatory, examination or compliance fees or expenses of the adviser or its related persons, unless these fees (and the dollar amounts thereof) have been disclosed to investors in writing within 45 days of the end of the fiscal quarter in which the charge occurs.
- Reducing the amount of any adviser clawback by the amount of actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners, without disclosing both the pre-tax and post-tax amounts of the clawback to investors within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.
- Charging fees or expenses related to a portfolio investment on a non-pro rata basis when more than one private fund or other client have invested in the same portfolio company, unless (1) the non-pro rata charge or allocation is fair and equitable under the circumstances and (2) the adviser distributes advance written notice of the non-pro rata charge and a description of how the allocation approach is fair and equitable.
- Borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client without disclosure of material terms to, and consent from, investors.[6]

Takeaways/Impressions

Each of these restrictions presents a change to existing market practices, as noted by the examples and discussions below:

- There is no definition in the Final Rules as to what constitutes an "investigation" and there are many open questions as to what the disclosure requirements would be for fees and expenses incurred in connection with, for example, responding to informal inquiries from a regulator, responding to a sweep examination that is designed to inform a regulator about a particular market practice, or providing information to a regulator that appears to be for the benefit of an investigation of another market participant. In the insurance industry, by analogy, there are more well-defined terms around what constitutes "formal" versus "informal" investigations that may prove useful for interpretive context, but even in the insurance space there are gray areas. In short, fees and expenses incurred in connection with any efforts that occur prior to the receipt of a subpoena, Wells Notice, target letter, search warrant, civil investigation demand or

[6] Advisers to commodity pools that are subject to the rules of the National Futures Association likely are already prohibited from borrowing money or other assets from their funds, pursuant to NFA Rule 2-45.

comparable document will require reasoned judgment calls as to whether these are "associated with an investigation."

- The restriction on charging certain fees and expenses to a private fund may cause certain advisers to reevaluate current assumptions and pricing models. For instance, the restriction includes certain fees and expenses charged or incurred by the adviser or its "related persons," a term broadly defined by the SEC without clarification of whether the private fund itself is captured by this term. Under the "related person" definition, a private fund might be captured depending on its legal form or the amount of the adviser's capital contributed, as all persons controlled by the adviser would be deemed to be "related persons."
- Because managers will be restricted from charging expenses 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*), they may be required to reconsider how broken deal expenses are allocated, including with respect to co-investments. Where a manager determines to move forward with a non-pro-rata methodology for allocating such expenses, it will have to determine that such an approach is fair and equitable and, effectively, show its work to investors with a written description of its determination and supporting rationale. In addition, records supporting this determination will now be required to be maintained by the adviser as a result of the amendments to Rule 204-2, as discussed below.
- The SEC noted that the Restricted Activities Rule's consent-based restrictions will require an adviser to seek consent from all fund investors and receive consent from at least a majority in interest of investors who are not related persons of the adviser. Although not a lot of detail was provided in the Adopting Release with respect to form and process for investor consent, negative consent was not expressly prohibited. There are also open questions with respect to what will constitute an investor that is "not a related person of the adviser" or how a "majority in interest" will be calculated, particularly for more complex structures that involve parallel funds and other alternative investment vehicles or special purpose vehicles. The Adopting Release also casts doubt on an adviser's ability to rely on limited partner advisory committees (LPACs) depending on their constitution. These interpretive issues, along with the process for obtaining consent after such issues have been reasonably resolved, could impact the timing for advisers to effectuate certain operational changes at the fund level.
- The requirement that advisers provide advance notice of non-pro rata fees and that those charges be fair and equitable could raise concerns over how an adviser can consistently make such fair and equitable determinations. For example, will fairness and equity be evaluated as of a point in time, or will a pattern of such determinations make it harder for an adviser to make such determinations over time? The SEC did not provide standards as to what would be a sufficient determination of whether such a charge is fair and equitable.
- All private fund advisers will need to review their expense, disclosure and investor consent policies and practices to ensure compliance with the Restricted Activities Rule.

Unlike the Proposal, the Final Rules do not explicitly prohibit advisers from charging portfolio investment monitoring fees, servicing fees, consulting fees, or other similar fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment. However, in the Adopting Release, the SEC noted that it considers the practice of charging fees to clients for a not-yet-performed service as inconsistent with an adviser's fiduciary duty, and therefore already prohibited, depending on the facts and circumstances. Accordingly, despite not adopting this provision in

the Final Rules, the SEC suggested that advisers should already be prohibiting such practices in most cases.

Further, the SEC chose not to adopt the Proposal's prohibition on private fund advisers' use of certain waiver or indemnification clauses in agreements with their private fund clients and investors. Recently, the SEC has brought enforcement actions under the theory that an adviser's use of contractual clauses that purport to limit an adviser's liability ("hedge" or "waiver" clauses) in an agreement would be inconsistent with the adviser's fiduciary duty to its clients or investors. In adopting the Final Rules, the SEC clarified that whether such contractual clauses in an agreement with a private fund or other institutional client would violate an adviser's fiduciary duty depends on the applicable facts and circumstances. Notably, the SEC maintained in the Adopting Release that a waiver of an adviser's compliance with its federal antifraud liability for breach of its fiduciary duty to any client (private fund or otherwise) is invalid under the Advisers Act. Accordingly, this change to the Final Rules also may not prove as helpful to private fund advisers as it might have first appeared.

PREFERENTIAL TREATMENT RULE (NEW RULE 211(H)(2)-3)

The new rule regarding preferential treatment for private fund investors (Preferential Treatment Rule) prohibits all advisers of private funds—regardless of whether they are registered with the SEC, relying on an exemption from registration (including, but not limited to, exempt reporting advisers), registered with one or more state securities regulators, or based in the US but entirely unregistered—from providing preferential liquidity terms to a subset of investors or providing portfolio holdings or investment exposure information to a subset of investors, with certain limited exceptions.

Specifically, advisers will be prohibited from providing preferential liquidity terms to investors if the adviser would reasonably expect such preferential liquidity to have a material, negative effect on other fund investors, unless (1) the redemption right is required by applicable law (e.g., certain government entity or sovereign investors) or (2) the adviser offers such liquidity to all other existing and future investors.

Advisers will also be prohibited from providing disclosure to select investors regarding information about portfolio holdings or investment exposure if the adviser reasonably expects such disclosure to have a material, negative effect on other private fund investors, unless the adviser provides that information to all investors at the same, or substantially the same, time.

Other "preferential treatment"—which is open-ended and undefined in the Final Rules—may only be afforded to investors if the adviser provides written disclosures of such preferential treatment to prospective and current investors. The Preferential Treatment Rule also requires an adviser to distribute to current investors a written notice of all preferential treatment the adviser or its related persons provided to other investors in the fund.

Specifically, for liquid funds, the adviser must provide such notice to an investor as soon as reasonably practicable after its investment and, for illiquid funds, the adviser must provide such notice to all investors as soon as reasonably practicable following the end of the fundraising period. For all funds, the adviser must also, on an ongoing basis and at least annually, provide notice to all investors of any preferential treatment that has been afforded to any other investor since the last delivery of a preferential treatment notice. In other words, any preferential treatment must be disclosed to all fund investors in perpetuity for the life of the fund.

Takeaways/Impressions

The Preferential Treatment Rule could significantly impact side letter and "most favored nations" election practices. The SEC acknowledged in the Proposal that some investors would find it difficult to secure preferential terms but went on to state that these types of preferential treatment are "contrary to the public interest and protection of investors." Further, the SEC noted that whether terms or information are considered preferential depends on the facts and circumstances.

Although the SEC stated that this standard will not require advisers to make such a prediction, advisers will be required to form a "reasonable expectation" as to whether redemption terms or certain information would have a material, negative effect on investors who do not receive the terms or information.

ANNUAL REVIEW OF COMPLIANCE PROGRAM (AMENDED RULE 206(4)-7)

Under the amendments adopted by the Final Rules, **all registered investment advisers** (*not just those that advise private funds*) will be required to document, in writing, the annual review of their compliance policies and procedures. Such documentation will help the SEC determine whether the adviser has complied with the SEC's compliance rule.

The SEC also indicated in the Adopting Release that it would expect copies of annual compliance program reviews to be producible in response to an inquiry within a few hours and no later than 24 hours under normal circumstances. The SEC also stated that because such reports are prepared for regulatory oversight purposes, it would consider them to *not* be protected by attorney-client privilege or the work product doctrine.

Although many advisers already prepare a written summary of their annual reviews under Rule 206(4)-7, the SEC's statements in the Adopting Release may prompt advisers to revisit and tighten up their current review processes and documentation practices.

RECORDKEEPING RULE (AMENDED RULE 204-2)

The SEC also amended Rule 204-2 (Books and Records Amendments) to require advisers to maintain multiple new records related to the Final Rules.

- For the Quarterly Statement Rule, advisers must maintain records with a copy of the quarterly statement (and each addressee and date sent), evidence of its calculation methods, and documentation substantiating the adviser's determination of liquid or illiquid.
- For the Audit Rule, advisers must maintain records with a copy of the audited financial statement (and each addressee and date sent), as well as, if applicable, the steps taken by an adviser to cause an uncontrolled private fund to undergo a financial audit.
- For the Adviser-Led Secondaries Rule, advisers must maintain records with a copy of the independent opinion and material business relationship summary (and each addressee and date sent).
- For the Preferential Treatment Rule, advisers must maintain records with a copy of all notifications, consents or other documents sent to current and prospective investors pursuant to the Preferential Treatment Rule (and each addressee and date sent).

In a change from the Proposal, the Books and Records Amendments do not require the maintenance of each addressee's address or the delivery method used to distribute the information in each of these instances. Nonetheless, these substantial new recordkeeping requirements will result in larger production volumes in response to examination inquiries, which will multiply the opportunity for examination staff to second-guess practices and make deficiency allegations.

APPLICATION TO NON-US ADVISERS

The Final Rules will not apply to non-US advisers, with respect to non-US funds they advise. According to the SEC, a "non-US adviser" means an adviser that has its principal office and place of business outside the United States. However, the Adopting Release makes it clear that the Preferential Treatment Rule and the Restricted Activities Rule will apply to "foreign private advisers," which are advisers with no place of business in the US, but who have at least one (but 14 or fewer) clients or investors in the US and up to $25 million attributable to assets under management from clients in the US or US investors in private funds.

COMPLIANCE DATES

The following chart outlines the various compliance dates of the Final Rules, which are keyed off the publication of the Final Rules in the *Federal Register*. Among adopted rules for the year-to-date in 2023, the publication timeline is averaging approximately 20 days, but has taken as much as 40 days.

RULE	COMPLIANCE DATE
• Audit Rule • Quarterly Statement Rule	18 months after publication in the *Federal Register*
• Adviser-Led Secondaries Rule • Preferential Treatment Rule • Restricted Activities Rule • Books and Records Amendments	Staggered depending on an adviser's private fund AUM: • $1.5B or more – 12 months after publication in the *Federal Register* • Less than $1.5B – 18 months after publication in the *Federal Register*
• Written Annual Review Amendments	60 days after publication in the *Federal Register*

In advance of the compliance dates outlined above, private fund advisers should consider reviewing their policies and procedures for any updates that may be needed to address the new requirements, including any necessary changes to meet the SEC's quarterly statements and audit requirements, as well as to limit or properly disclose any applicable restricted activities and preferential treatment. Private fund advisers should also take note of when their regulatory assets under management exceed the threshold for a larger private fund adviser under the Advisers Act (under the Final Rules, $1.5 billion), because they may, at that time, be subject to the shorter transition periods applicable to larger private fund advisers.

LEGACY STATUS

In its discussion on implementing the Final Rules, the SEC noted that several commenters sent suggestions to provide "legacy status" where the Final Rules would not apply to existing funds and their contractual agreements, with various suggestions as to an applicable timeframe. Although "legacy status" was not considered in the Proposal, the Final Rules do grant such legacy status under certain instances of the Preferential Treatment Rule and the Restricted Activities Rule. However, the legacy treatment is rather limited, and no current fund will be completely unaffected by the Final Rules. In particular, the Preferential Treatment Rule only affords legacy treatment with respect to the preferential liquidity and portfolio holdings/investment exposure disclosure elements, and only where compliance with those elements would require the applicable private fund to amend its governing agreements. The catch-all prohibition on other preferential treatment would apply to all current private funds.

Similarly, under the Restricted Activities Rule, legacy treatment would be available only with respect to the provisions for fees and expenses related to investigations and the borrowing provisions, and—once again—only where compliance would require the applicable private fund to amend its governing agreements. The other three parts of the Restricted Activities Rule will apply to private funds currently in existence. Furthermore, in no event will any private fund—whether currently in existence or formed after the compliance date—be permitted to pass along fees and expenses relating to an investigation that results in a sanction imposed under the Advisers Act or the rules thereunder.

WHAT'S NEXT?

The Final Rules represent a significant overhaul of the private fund industry's regulatory regime. The investor reporting requirements, in particular, likely will lead to an industry shift in how advisers charge funds for certain fees and expenses and how they report to investors. The implementation of changes in advisers' operations also could lead to additional administrative burdens on advisers and increased costs that are generally passed on (and disclosed) to investors.

The Adopting Release also refers in multiple instances to comment letters from several industry participants that did not believe the Advisers Act authorized implementation of several rules in the Proposal, and that the Proposal was overly broad in scope relative to the SEC's authority under the Advisers Act, particularly with respect to Section 211(h), which was added to the Advisers Act in the Dodd-Frank Act. Several industry organizations have expressed similar concerns about the Final Rules, including that the Final Rules affect private fund structuring that is more suitable for Investment Company Act governance (rather than adviser regulation under the Advisers Act), and are strategizing their response, including the potential for related litigation. Indeed, many in the industry view Commissioner Peirce's dissenting remarks on the rule adoption as a roadmap for potential legal challenges that could be brought against the Final Rules. Morgan Lewis will continue to monitor any developments with respect to the dynamics of industry reactions or whether any legal delays are imposed on the compliance dates of the Final Rules.

It is also worth noting that the SEC explained in the Adopting Release that an intended effect of the rules is to respond to harms arising out of private fund governance structures. In particular, the release includes an extensive discussion about private funds with LPACs or boards of directors, expressing concern that "these types of bodies may not have sufficient independence, authority, or accountability to oversee and consent to these conflicts," and noting that they "do not have a fiduciary obligation to the private fund investors." This scrutiny on a long-established industry standard, as well as the expanded information and consent rights granted to investors under the Final Rules, could see the industry moving away from reliance on LPACs or boards for fund-wide consents.

CONTACTS

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