

The SEC Adopts Significant New Rules for Private Fund Advisers

by David Tang and Michael Schmieder

On August 23, 2023, the Securities and Exchange Commission (“SEC”) adopted new rules and rule amendments (the “Final Rules”) under the Investment Advisers Act of 1940 (“Advisers Act”) to enhance the regulation of private fund advisers.^[1] The Final Rules also update the existing compliance rule under the Advisers Act that applies to all registered investment advisers. The SEC designed the Final Rules to protect private fund investors 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.”^[2]

Certain Notable Changes from the Proposed Rules

The Final Rules include certain notable changes from the private fund adviser rules originally proposed by the SEC in February 2022 (the “Proposed Rules”).^[3]

- Unlike the Proposed Rules, the Final Rules do not flatly prohibit the restricted activities discussed below. Instead, the Final Rules permit advisers to engage in the restricted activities subject to providing investor disclosure, and in certain cases, obtaining investor consent.
- The Final Rules do not include the prohibition in the Proposed Rules on charging a private fund portfolio company for services not provided, such as, for example, accelerated monitoring fees.
- The SEC did not adopt the Proposed Rule’s prohibition on an adviser seeking reimbursement, indemnification, exculpation, or limitation of liability by the private fund or its investors for the adviser’s breach of fiduciary duty, willful malfeasance, bad faith, negligence, or recklessness in providing services to the private fund.
- As discussed below, the Final Rules include limited exceptions to the restricted activities rule and parts of the preferential treatment rule for private funds that have commenced operations as of the applicable compliance date.

The following is an overview of the requirements of the Final Rules on registered

Related People

- David Tang
- Michael Schmieder

Related Capabilities

- Investment Funds
- Investment Management

investment advisers, and, with respect to certain requirements, unregistered exempt private fund advisers.

Quarterly Statements

The Final Rules require a registered investment adviser to prepare a quarterly statement for any private fund that it advises that has at least two full fiscal quarters of operating results, and distribute the quarterly statement to the private fund's investors within a specified time period after each fiscal quarter.^[4] The quarterly statement must include:

- a. A fund table that discloses, at a minimum: (1) a detailed accounting of all compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons^[5] by the private fund during the reporting period, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation; (2) a detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and (3) the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the adviser or its related persons;
- b. A portfolio investment table for the private fund's investments that discloses, at a minimum, a detailed accounting of all portfolio investment compensation allocated or paid to the investment adviser or any of its related persons by the covered portfolio investment during the reporting period, presented both before and after the application of any offsets, rebates, or waivers;
- c. Prominent disclosure regarding the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated and cross references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology; and
- d. The private fund's performance, which,
 1. For a liquid fund,^[6] includes annual net total returns for each fiscal year over the past 10 fiscal years or since inception, whichever time period is shorter; average annual net total returns over one-, five-, and 10-fiscal-year periods; and the cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement, or
 2. For an illiquid fund, includes gross IRR and gross MOIC for the illiquid fund; net IRR and net MOIC for the illiquid fund; gross IRR and gross MOIC for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately, and a statement of contributions and distributions for the illiquid fund.^[7]

Annual Private Fund Audits

The Final Rules require a registered investment adviser to cause each private fund that it advises (other than a securitized asset fund)^[8] to undergo an annual financial statement audit that meets the requirements of the annual audit exception of the custody rule^[9] under the Advisers Act, and cause the audited financial statements to be delivered to the private fund's investors in accordance with the annual audit exception.^[10]

Adviser-led Secondaries

The Final Rules require a registered investment adviser conducting an adviser-led secondary transaction^[11] with respect to any private fund that it advises (other than a securitized asset fund) to, in each case, prior to the due date of the election form in respect of the adviser-led secondary transaction:

- a. Obtain, and distribute to investors in the private fund, a fairness opinion or valuation opinion from an independent opinion provider; and
- b. Prepare, and distribute to investors in the private fund, 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.^[12]

Restricted Activities

Under the Final Rules,^[13] an investment adviser to a private fund (other than a securitized asset fund), whether or not registered with the SEC, may not, directly or indirectly, do the following with respect to the private fund, or any investor in that private fund:

- a. 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, unless the investment adviser requests each investor of the private fund to consent to, and 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; provided, however, that the investment adviser may not charge or allocate to the private fund 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;
- b. 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, unless the investment 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;
- c. Reduce the amount of an adviser clawback^[14] by actual, potential, or hypothetical

taxes applicable to the adviser, its related persons, or their respective owners or interest holders, unless the investment adviser distributes 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;

d. Charge or allocate fees or expenses 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 (other than a securitized asset fund) have invested (or propose to invest) in the same portfolio investment, unless (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 investment 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; and

e. Borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client, unless 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 restrictions with respect to adviser investigation expenses and adviser borrowings in the restricted activities rule will not apply to contractual agreements governing a private fund (and contractual agreements governing a borrowing, loan, or extension of credit entered into by a private fund) that has commenced operations as of the applicable compliance date^[15] of the restricted activities rule and that were entered into in writing prior to the compliance date if the restricted activities rule would require the parties to amend such governing agreements; provided that this exception does not permit an investment adviser to such a fund to charge or allocate to the private fund 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.

Preferential Treatment

Under the Final Rules,^[16] an investment adviser to a private fund (other than a securitized asset fund), whether or not registered with the SEC, may not, directly or indirectly, do the following with respect to a private fund, or any investor in that private fund:

a. Grant an investor in the private fund or in a similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a similar pool of assets, except: (i) if such ability to redeem is required by the applicable laws, rules, regulations, or orders of any relevant foreign or U.S. Government, State, or political subdivision to which the

investor, the private fund, or any similar pool of assets is subject; or (ii) if the investment adviser has offered the same redemption ability to all other existing investors, and will continue to offer such redemption ability to all future investors, in the private fund and any similar pool of assets; or

b. Provide information regarding the portfolio holdings or exposures of the private fund, or of a similar pool of assets, to any investor in the private fund 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, except if the investment adviser offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time.

The preferential treatment rules above will not apply to contractual agreements governing a private fund that has commenced operations as of the compliance date^[17] and that were entered into in writing prior to the compliance date if the above preferential treatment rules would require the parties to amend such governing agreements.

The Final Rules provide further that an investment adviser to a private fund (other than a securitized asset fund), whether or not registered with the SEC, may not, directly or indirectly, provide any preferential treatment to any investor in the private fund unless the adviser provides the following written notices:

a. *Advance written notice for prospective investors in a private fund.* The investment adviser must provide to each prospective investor in the private fund, prior to the investor's investment in the private fund, a written notice that provides specific information regarding any preferential treatment related to any material economic terms that the adviser or its related persons provide to other investors in the same private fund.

b. *Written notice for current investors in a private fund.* The investment adviser must distribute to current investors:

1. For an illiquid fund, 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;
2. For a liquid fund, 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; and
3. On at least an annual basis, a written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided in accordance with the preferential treatment rule, if any.

Recordkeeping

The Final Rules amend the recordkeeping rule under the Advisers Act to require

registered investment advisers to maintain books and records related to the quarterly statement, annual audit, adviser-led secondaries, and preferential treatment rules.^[18]

Written Annual Compliance Reviews

The Final Rules amend the compliance rule under the Advisers Act to require registered investment advisers to document their annual compliance reviews in writing.^[19]

Compliance Dates

The Final Rules provide for the following compliance dates:

Rule	Applicability	Compliance Date for Large Private Fund Advisers (advisers with \$1.5 billion or more in private fund assets under management)	Compliance Date for Smaller Private Fund Advisers (advisers with less than \$1.5 billion in private fund assets under management)
Quarterly Statements 211(h)(1)-2	Registered investment advisers	March 14, 2025 (18 months after publication in the Federal Register)	March 14, 2025 (18 months after publication in the Federal Register)
Annual Private Fund Audits 206(4)-10	Registered investment advisers	March 14, 2025 (18 months after publication in the Federal Register)	March 14, 2025 (18 months after publication in the Federal Register)
Adviser-led Secondaries 211(h)(2)-2	Registered investment advisers	September 14, 2024 (12 months after publication in the Federal Register)	March 14, 2025 (18 months after publication in the Federal Register)
Restricted Activities 211(h)(2)-1	All private fund advisers	September 14, 2024 (12 months after publication in the Federal Register)	March 14, 2025 (18 months after publication in the Federal Register)
Preferential Treatment 211(h)	All private fund advisers	September 14, 2024 (12 months after publication in the Federal Register)	March 14, 2025 (18 months after publication in the Federal Register)

(2)-3		after publication in the Federal Register)	publication in the Federal Register)
Written Annual Compliance Reviews 206(4)-7	Registered investment advisers	November 13, 2023 (60 days after publication in the Federal Register)	November 13, 2023 (60 days after publication in the Federal Register)

Dorsey Observations

The Final Rules impose significant new obligations on private fund advisers. Private fund advisers will be well-advised to adopt and implement written policies and procedures reasonably designed to ensure compliance with the Final Rules. For example, private fund advisers should develop or modify its template private fund quarterly statement to satisfy the content and formatting requirements of the quarterly statement rule. Private fund advisers will be required to make certain determinations under the Final Rules, such as whether a preferential redemption or portfolio information term provided to an investor through a side letter is reasonably expected to have a material, negative effect on other investors in the private fund. Private fund advisers with a view towards launching new funds should carefully note the compliance dates for the restricted activities and preferential treatment rules, which vary depending on the amount of private fund assets managed by the adviser. Private funds that are launched after the compliance dates must comply with the restricted activities and preferential treatment rules, and prepare and distribute the required preferential treatment notices to prospective and current investors.

Dorsey's investment management group will continue to monitor for any further guidance from the SEC on the Final Rules. Dorsey's regulatory compliance services are available to assist private fund managers with compliance with the Final Rules, including the design and implementation of new or modified policies and procedures.

[1] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-6383 (Aug. 23, 2023) (the "Release") available at <https://www.sec.gov/files/rules/final/2023/ia-6383.pdf>.

[2] Release, at page 1.

[3] See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955 (Feb. 9, 2022) available at <https://www.sec.gov/files/rules/proposed/2022/ia-5955.pdf>.

[4] Quarterly statements must be distributed to the private fund's investors, if the private fund is not a fund of funds, within 45 days after the end of each of the first three fiscal quarters of each fiscal year of the private fund, and 90 days after the end of each fiscal

year of the private fund, and, if the private fund is a fund of funds, within 75 days after the end of the first three fiscal quarters of each fiscal year, and 120 days after the end of each fiscal year. Quarterly statements may be prepared and distributed by a person other than the adviser. 17 CFR § 275.211(h)(1)-2(a).

[5] Related person is defined as “(1) all officers, partners, or directors (or any person performing similar functions) of the adviser; (2) all persons directly or indirectly controlling or controlled by the adviser; (3) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (4) any person under common control with the adviser.”

[6] Liquid fund is defined as “private fund that is not an illiquid fund.” Illiquid fund is defined 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.”

[7] Gross IRR is defined as “an internal rate of return that is calculated gross of all fees, expenses, and performance-based compensation borne by the private fund” and gross MOIC is defined as “a multiple of invested capital that is calculated gross of all fees, expenses, and performance-based compensation borne by the private fund.” Net IRR is defined as “an internal rate of return that is calculated net of all fees, expenses, and performance-based compensation borne by the private fund” and net MOIC is defined as “a multiple of invested capital that is calculated net of all fees, expenses, and performance-based compensation borne by the private fund.”

[8] Securitized asset fund is defined as “any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders.”

[9] 17 CFR § 275.206(4)-2(b)(4).

[10] The Final Rules require a registered investment adviser to take all reasonable steps to cause a private fund that the adviser does not control and is neither controlled by nor under common control with to undergo a financial statement audit and to cause audited financial statements to be delivered in accordance with the custody rule. 17 CFR § 275.206(4)-10.

[11] 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: (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.”

[12] 17 CFR § 275.211(h)(2)-2.

[13] 17 CFR § 275.211(h)(2)-1.

[14] Adviser clawback is defined as “any obligation of the adviser, its related persons, or

their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements.”

[15] See the compliance date for the restricted activities rule discussed below.

[16] 17 CFR § 275.211(h)(2)-3.

[17] See the compliance date for the preferential treatment rule discussed below.

[18] 17 CFR § 275.204-2.

[19] 17 CFR § 275.206(4)-7.