> Client Alert

Long Anticipated Private Funds Rule Adopted by SEC, Requiring Significant Changes for Investment Advisers

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An SEC split along party lines approved rules on August 23, 2023 (the "Private Funds Rule") to increase the transparency and oversight of private funds. The final version of the Private Funds Rule scales back some of the outright prohibitions in the proposed rule that could have shifted the balance of power between sophisticated investors and private fund advisers, now requiring either disclosure or consent. The Private Funds Rule does not apply to advisers to "securitized asset funds," which would cover advisers to CLO, CDO and other similar asset-backed vehicles.

The Private Funds Rule is comprised of five separate rules, each of which is further discussed below and include: (i) the quarterly statement rule, (ii) the adviser-led secondary rule, (iii) the audit rule, (iv) the preferential treatment rule, and (v) the restricted activities rule. The SEC also adopted changes to Rule 206(4)-2 requiring investment advisers to keep certain books and records in connection with the Private Funds Rule. Finally, in addition to the Private Funds Rule, the SEC adopted a change to Rule 206(4)-7 which will require investment advisers to document their annual compliance review.

Quarterly Statement Rule

The Quarterly Statement Rule requires investment advisers to provide investors with meaningful disclosure on performance, fees and expenses and, in the SEC's view, is meant to decrease the likelihood of fraudulent, deceptive or manipulative conduct, and increase the likelihood that any such misconduct will be detected earlier. The Quarterly Statement Rule requires private fund advisers that are registered to send a quarterly statement to investors within 45 days after the end of each of the first three fiscal quarters, and 90 days after the fiscal year end. For fund of funds specifically, the timing is 70 days and 120 days, respectively. Such reporting is at the fund-level as opposed to investor-level, and is not required on a class-by-class basis. The Quarterly Statement Rule can be broken down into the following three components:

i. *Private Fund Level Disclosure*: The quarterly statements must contain, in a table format: (i) a detailed accounting of all compensation, fees and other amounts allocated or paid by the private fund to the adviser or any of its related persons during the reporting period, (ii) a detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period

other than those listed in (i), and (iii) the amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons. The requirements should be read broadly and will require significant disclosure of all fees and expenses paid by or allocated to private funds, including organizational, accounting, legal, administration, audit, tax, due diligence and travel expenses in line item format.

ii. *Portfolio Investment Level Disclosure*: The Quarterly Statement Rule requires advisers to disclose a detailed accounting of all "portfolio investment compensation" allocated or paid by each "covered portfolio investment" during the reporting period in a single table. A covered portfolio investment is any entity or issuer in which the private fund has invested, directly or indirectly. It is intended to be broad and cover holding companies and underlying subsidiaries of the holding companies in which the private fund holds an investment. Portfolio investment compensation is compensation paid to the investment adviser or its related person and includes, without limitation, origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments by the covered portfolio investment.

iii. *Performance Disclosure*: The Quarterly Statement Rule requires investment advisers to show various performance metrics to investors, which vary between liquid and illiquid funds. For liquid funds, advisers will be required to show performance based on net total return on an annual basis for the ten fiscal years prior to the quarterly statement or since the fund's inception, over one, five, and ten year periods and on a cumulative basis for the current fiscal year as of the end of the most recent fiscal quarter, as well as average annual net total returns over the applicable time periods. For illiquid funds, advisers will be required to show performance based on internal rates of return and multiples of invested capital since inception, both gross and net, and broken down between realized and unrealized investments, and to present a statement of contributions and distributions. Investment advisers to illiquid funds must show performance with and without the impact of subscription facilities. The proposed rule only required advisers to show performance for illiquid funds without the impact of subscription facilities. The rule requires all private funds, whether liquid or illiquid, to provide quarterly statements after the first two fiscal quarters of operating results.

The determination of whether a fund is a liquid fund or an illiquid fund turns on whether (i) the fund is required to redeem interests upon an investor's request, and (ii) has limited opportunities, if any, for investors to withdraw before the termination of the fund.

Adviser-Led Secondaries Rule

The Adviser-Led Secondaries Rule will require any registered private fund adviser to obtain a fairness opinion or independent valuation from an independent opinion provider in connection with any adviser-led secondary transaction and provide such opinion to investors prior to the time an election is due in connection with the proposed transaction. Private fund advisers will also be required to provide a summary of any material business relationship with the opinion provider within the two-year period before the issuance of the opinion.

The SEC defined an adviser-led secondary transaction as a transaction in which investors must be faced with a decision between (1) selling all or a portion of its interest or (2) converting of exchanging all or a portion

of its interest. In a change from the proposal, the SEC eliminated tender offers from the definition of an adviser-led secondary transaction because investors are not presented with the choice between the foregoing two options.

Private Fund Audit Rule

The Private Fund Audit Rule will now require registered investment advisers to obtain an annual audit with respect to each private fund that is an advisory client. The Private Fund Audit Rule generally follows the Custody Rule requirement, applicable to registered investment advisers, for an audit. There were a few differences between the audit requirement in the proposed rule and the Custody Rule, which the SEC acknowledged and eliminated. In practice, as long as registered investment advisers were already obtaining an audit for their private fund clients and sending audited financial statements to investors in such private funds within 120 days of fiscal year-end, there are no new requirements for registered investment advisers. However, if an investment adviser was complying with the Custody Rule by conducting a surprise audit, such investment adviser will now need to obtain an audit for the private funds that were previously utilizing surprise audits to comply with the Custody Rule. Effectively, the Private Fund Audit Rule eliminates the use of the "surprise audit" under the existing Custody Rule.

With respect to investment advisers that are in sub-advisory or non-control relationships with the private funds that they manage, such investment advisers will need to use reasonable efforts to cause such private funds to obtain an audit. If the investment adviser is aware that the private fund is going to obtain an audit, the investment adviser will not have further obligations. The rule release states that if an investment adviser is in a sub-advisory or non-control position, it could evidence its reasonable efforts by seeking to include the requirement in its sub-advisory agreement.

Preferential Treatment Rule

The Preferential Treatment Rule will impact the manner in which private fund advisers are able to enter into side letters with investors in private funds that they manage.

Private fund advisers will no longer be permitted to offer investors preferential liquidity or information rights, in each case, that the adviser reasonably expects to have a material negative effect on other investors in that private fund, without offering such rights to all other existing investors. Advisers must also offer such redemption rights or information rights to all future investors in the private fund and any similar pool of assets. In the case of redemption rights, private fund advisers may offer preferential liquidity if the ability to redeem is required by law, regulation or orders of the U.S. or a foreign government, state or political subdivision to which the investor, the private fund or any similar pool of assets is subject. Thus, as an example, if a preferential redemption were to be required due to a potential violation of ERISA, such preferential redemption would be permitted.

With respect to preferential terms that do not relate to preferential liquidity or information rights, such preferential terms must be disclosed in writing to any investor in the private fund on a pre-investment basis. The written notice must provide 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. At the SEC's open meeting, there was discussion amongst the commissioners about what constitutes a "material economic term" and whether the requirement to provide information regarding these preferential terms to all investors is in fact a prohibition on providing preferential terms. While we believe that investment advisers will still be able to provide preferential terms to investors on a "most favored nations" basis, we are mindful of the subjective interpretation of what a "material economic term" is and are hopeful that the SEC may provide further written guidance on this topic.

For liquid funds, all preferential terms must be disclosed as soon as practicable following the investor's investment in a private fund, and for illiquid funds, all preferential terms must be disclosed as soon as reasonably practicable following the end of the fundraising period. All private fund advisers must provide, 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 to investors.

Restricted Activities Rule

The Restricted Activities Rule restricts private fund advisers from engaging in the following activities unless the private fund adviser satisfies certain disclosure, and in some cases, consent requirements:

i. Private fund advisers may not 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 private fund adviser has received consent from investors. If the adviser is found to have violated the Investment Advisers Act or the rules promulgated thereunder, such adviser may not charge or allocate such fees to the private fund regardless of disclosure or consent. If there are such charges to the fund, the adviser must provide disclosure to investors within 45 days after the end of the quarter in which the relevant activity occurs.

ii. Private fund advisers may not charge the private fund for any regulatory, examination or compliance fees or expenses of the adviser or its related persons without providing disclosure to investors.

iii. Private fund advisers may not reduce 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 or interest holders without providing disclosure to investors. Such practice requires disclosure not only in the fund's documents but also following a clawback. The private fund adviser will need to share the aggregate dollar amount of the clawback, both before and after the application of any tax reduction, with investors within 45 days of the end of the quarter in which the clawback is paid.

iv. Private fund advisers may not charge or allocate fees or expenses relating to a portfolio investment on a non-pro rata basis when more than one private fund or other client advised by the adviser or its related persons have invested in the same portfolio company without disclosure to investors prior to charging or allocating such non-pro rata fees or expenses. In order for an adviser to make such non-pro rata allocations, the new rule has two requirements. First, the non-pro rata charge must be fair and equitable under the circumstances. Second, prior to charging or allocating such fees or expenses to a private fund client, the adviser must distribute to each investor of the private fund a written notice of the non-pro rata charge and a description of how it is fair and equitable under the circumstances.

v. Private fund advisers may not borrow money, securities or other private fund assets, or receive a loan or extension of credit, from a private fund client without disclosure and consent from at least a majority in interest of the private fund investors.

Many will view the Restricted Activities Rule as the portion of the Private Fund Adviser Rule with the most significant differences from the proposal, which would have outright prohibited the above activities. Many in

the private fund industry believed that the outright prohibitions exceeded the SEC's authority and adoption of the proposal as had been drafted would have resulted in litigation against the SEC challenging the rule. It is still possible that industry groups within the private fund industry will seek to challenge the SEC's authority to pass some of the rules included in the Private Fund Advisers Rule. "Notably, during the SEC's open meeting, Commissioners Hester Peirce and Mark Uyeda were vocal about some of the issues raised by commenters regarding the SEC's authority to pass some of these rules under either 206(4) or 211(h) of the Advisers Act, which is the Congressional authority the SEC relied upon in passing these rules.

Annual Compliance Review Rule

The amendment to Rule 206(4)-7 is not specifically dedicated to private fund advisers but rather is applicable to all registered investment advisers. The annual compliance review required by Section 206(4)-(7) is now required to be in writing and shall be kept in the records of the investment adviser. We note that while there was previously no requirement to document such review, it was common market practice to document such annual reviews in writing and is helpful for registered investment advisers in the SEC examination process, as examiners typically ask for documentation regarding an investment adviser's 206(4)-7 review in their document requests.

Applicability of New Rules

Exempt reporting advisers, state registered advisers and other investment advisers will only be subject to the Restricted Activities Rule and the Preferential Treatment Rule. The foregoing two rules also receive the benefit of "legacy" status. If an adviser has in place a written agreement with an investor or a governing agreement of a fund or SPV prior to the compliance date, such adviser will not need to amend such agreements in order to adhere to the Restricted Activities Rule and the Preferential Treatment Rule. Registered investment advisers will be subject to all aspects of the new Private Fund Adviser Rule.

Compliance Dates

The Private Funds Rule has the following compliance dates: (i) the compliance date for the Private Fund Audit Rule and the Quarterly Statement Rule is 18 months after publication in the Federal Register; (ii) the compliance date for the Adviser-Led Secondaries Rule, the Preferential Treatment Rule, and the Restricted Activities Rule is 12 months after publication in the Federal Register for advisers with at least $1.5 billion private fund assets under management and 18 months after publication in the Federal Register for advisers under the $1.5 billion threshold; and (iii) the compliance date for amended Rule 206(4)-7 is 60 days after publication in the Federal Register.

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The Morrison Cohen Investment Funds & Advisers team is available to provide regulatory advice to investment advisers in the rapidly changing regulatory environment.