NOW & NEXT

Securities Alert

SEPTEMBER 14, 2023

SEC issues private fund adviser 2023 final rules

By John P. Beals, Matthew Bobrow, William E. Kelly, Benedict Kwon, John C. Partigan, Todd Tidgewell, and Marc Zhang

SEC has finalized significant new rules and changes that will impact all fund advisers across the entire industry.

What's the Impact?

- The reforms are designed specifically to address risks that the SEC believes are common in an adviser's relationship with private funds and their investors.
- Requirements for both registered investment advisers and all advisers are clearly delineated in the final rules.
- Funds that are already in existence and newly planned funds will need to prepare disclosures for compliance with the new rules.

On August 23, 2023, the Securities and Exchange Commission (SEC) voted 3 to 2 to finalize significant new rules and changes under the Investment Advisers Act of 1940 (Advisers Act) that will impact all fund advisers across the entire industry including those that are not required to be registered with the SEC. The final rules are a scaled-back version of the proposed rules, which we previously summarized. The private fund adviser reforms are designed specifically to address three risks that the SEC believes are common in an adviser's relationship with private funds and their investors: (1) lack of transparency; (2) conflicts of interest; and (3) lack of effective governance mechanisms for client disclosure, consent, and oversight.

This newsletter is intended as an information source for the clients and friends of Nixon Peabody LLP. The content should not be construed as legal advice, and readers should not act upon information in the publication without professional counsel. This material may be considered advertising under certain rules of professional conduct. Copyright © 2023 Nixon Peabody LLP. All rights reserved.

The new rules that apply to only registered investment advisers are the "Quarterly Statement Rule," "Private Fund Audit Rule," and "Books and Records Rule." The new rules that apply to all advisers are the "Restricted Activities Rule" and "Preferential Treatment Rule."

While the rules have been adopted, that was not without opposition from members of Congress and even certain SEC Commissioners. Two quotes are in juxtaposition: (1) SEC Chair Gary Gensler said, "By enhancing advisers' transparency and integrity, we will help promote greater competition and thereby efficiency. Consistent with our mission and Congressional mandate, we advance today's rules on behalf of all investors — big or small, institutional or retail, sophisticated or not," while (2) SEC Commissioner Mark T. Uyeda said, "Today, the Commission seeks to impose rules for private funds — which are generally available only for sophisticated investors — that are far more burdensome and restrictive than those products for retail investors. This inconsistency is only one reason why these final rules are arbitrary and capricious."

In addition, industry groups have filed a legal challenge to the rule that is pending in the Fifth Circuit.

What are the new requirements that impact Registered Private Fund Advisers only?

The rules requiring quarterly statements, annual audits, and opinions and summaries for adviser-led secondaries will not apply with respect to non-US private fund clients of an SEC-registered offshore adviser (regardless of whether they have U.S. investors). The rules (i) requiring quarterly statements, annual audits, opinions, and summaries for adviser-led secondaries, and (ii) prohibiting certain activities and preferential treatment, each do not apply to investment advisers with respect to securitized asset funds they advise.

Quarterly Statements

Private fund investors must receive *quarterly* statements with:

I. ***Fund-level*** information regarding performance. To the extent quarter-end numbers are not available at the time of distribution of the quarterly statement, an adviser is required to include performance measures through the most recent practicable date, which would be through the end of the quarter immediately preceding the quarter covered by the quarterly statement.
    A. Advisers to illiquid funds (i.e., those with minimal withdrawal and redemption capability) are required to calculate gross IRR[i]/MOIC[ii] (with realized and unrealized performance shown separately) and net IRR/MOIC[iii] ***with and without*** the impact of subscription loan facilities (since inception) with a statement of contributions and distributions.
    B. For performance measures *without the impact of fund-level subscription facilities*, the rule requires advisers to calculate performance measures as if the private fund called on investor capital, rather than drawing down on fund-level subscription facilities. For performance measures *with the impact of fund-level subscription facilities*, the rule requires advisers to calculate performance measures reflecting the actual capital activity

from both investors and fund-level subscription facilities, including, for the avoidance of doubt, any activity before investor capital contributions as a result of the fund drawing down on fund-level subscription facilities.

C. The statement of contributions and distributions must include (i) all capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund's inception, with the value and date of each inflow and outflow; and (ii) the net asset value of the private fund as of the end of the reporting period covered by the quarterly statement. Advisers should treat any distributions that they recall for additional investments (e.g., recycling) as additional contributions for purposes of calculating these illiquid fund performance metrics.

D. For liquid funds, performance shown must be based on the net total return on an annual basis for the 10 fiscal years before the quarterly statement (if any). In addition, the statement will need to include the cumulative net total return for the current fiscal year and the average net total returns over the one-, five-, and 10-year periods.

E. Different categories of performance information must be shown with equal prominence.

F. Any off-market assumptions (e.g., highly irregular valuation practices not used by similarly situated advisers) used in calculating performance must be disclosed.

II. *The cost of investing including compensation, fees, and expenses paid (i) by, or allocated to, the private fund, and (ii) to the adviser or its related persons.*[iv]

A. All compensation, fees (e.g., monitoring), and expenses paid from the fund's portfolio companies, as well as intermediate holding companies, must be traced. If the adviser performs a non-advisory service to the fund, such as back-office services, the expense should be disclosed as adviser compensation, rather than a general expense, such as back-office expenses.

B. The requirement excludes distributions representing profit or return of capital to the fund in respect of the fund's interest in an investment (since that situation does not present conflicts).

C. Funds of funds are not excluded and are required to disclose, as a separate line item for each category, amounts that are not only paid by the parent fund, but also those allocated to the parent fund from the underlying fund. In addition, to the extent a portfolio investment indirectly held by the parent fund (i.e., a portfolio company of the underlying fund) pays a fee to the adviser of the parent fund, such amounts must be separately disclosed. The adviser to the parent fund should be able to determine whether an entity paying the adviser or its related person is a portfolio company of the underlying fund. Given a potential lack of information, funds of funds may have to rely on good faith belief to determine which entities constitute portfolio investments and may consider documenting this determination and its ongoing efforts to better inform its determination.[v]

D. Advisers should generally disclose the identity of each covered portfolio investment to the extent necessary for an investor to understand the nature of the potential or actual conflicts associated with such payments. To the extent the identity of any covered portfolio investment is not necessary for an investor to understand the nature of the conflict, advisers may use consistent code names (e.g., "portfolio investment A").

Report Disclosure

A. Each quarterly statement must include a prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated.
B. This must include the structure of, and method used to determine, any performance-based compensation set forth in the quarterly statement (such as the distribution waterfall, if applicable), any assumptions made therein (without linking to an external document), and the criteria on which each type of compensation is based (e.g., whether such compensation is fixed, based on performance over a certain period, or based on the value of the fund's assets).
C. In addition, this must include cross-references to the relevant sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.
D. If there are additional non-required elements in the statement, it might be an "ad" subject the marketing rule.

Timing of Reports

A. If the private fund is *not* a fund of funds, the quarterly statement must be distributed no later than 45 days after the end of each of the first three fiscal quarters and 90 days after the end of the fiscal year.
B. If the private fund *is* a fund of funds, the quarterly statement must be distributed no later than 75 days after the end of each of the first three fiscal quarters and 120 days after the end of the fiscal year.

Table Format

A. A table should be used to describe #3 above and should include the amount of any offsets, rebates, or waivers (for the adviser, its related persons or any investors) depicting the compensation and expenses both before and after their application, and should include the amount of any offset, rebate, or waiver carried forward from a prior reporting period.
B. Separate line items should be made for each category of allocation or payment reflecting the total dollar amount (but there is no prescription for particular categories). "Miscellaneous" is not a permissible label for a category.
C. There is no *de minimis* exception or ability to group smaller expenses into broad categories.

Newly Formed Funds

A. The first report covers a fund's first two fiscal quarters of operating results.
B. To the extent a newly formed private fund begins generating operating results on a day other than the first day of fiscal quarter, the adviser should include the initial partial quarter and the immediately succeeding fiscal quarters in the fund's initial quarterly statement. For example, if a fund begins generating operating results on February 1, the

reporting period for the initial quarterly statement would cover the period beginning on February 1 and ending on September 30.

Annual Audits

Private funds controlled by an adviser must undergo an *annual financial statement audit* that meets the requirements of the audit provision in the Advisers Act custody rule (Rule 206(4)-2)).

I. This requires:
   A. GAAP be used,
   B. Delivery to investors be made annually within 120 days of the fiscal year end and promptly upon liquidation,
   C. The audit meet the definition of an "audit" in Regulation S-X,[vi] and
   D. The audit be performed by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB) in accordance with its rules.

II. An auditor must inquire about related party relationships and transactions, including the identity of any related parties, the nature of the relationships, and the business purpose of entering into any transaction with a related party.

III. The auditor has a responsibility to obtain reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.

IV. Unaffiliated sub-advisers that do not control a fund need to take all reasonable steps to cause the fund they advise to undergo an audit that meets these elements.

Opinions for Adviser-Led Secondaries

A fairness opinion *or* a valuation opinion is required when offering existing fund investors the option between selling their interests in a private fund and converting or exchanging their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons (e.g., continuation funds).

I. The opinion must be provided by a person who provides fairness opinions or valuation opinions in the ordinary course of their business and is not a related person of the adviser.

II. Investors must also receive a summary of any material business relationships the adviser has and the independent opinion they have provided, or have had within the two years immediately before the issuance of the opinion.

III. Whether a business relationship is material requires a facts and circumstances analysis; however, for purposes of the rule, audit, consulting, capital raising, investment banking, and other similar services would typically meet this standard.

IV. The opinion and summary of relationships must be distributed before the due date of the election form for the transaction.

Books and Records

The recordkeeping rule was updated to include a requirement to retain books and records related to the new rules on quarterly statements, annual audits, adviser-led secondaries, and preferential treatment (as described herein).

I. Advisers are required to maintain and preserve the records in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made to such record, with the records maintained for the first two years in an appropriate office of the fund adviser.

II. For the quarterly statements, advisers should retain:
   - A. The statements themselves,
   - B. The addresses of investors to which the statements were sent,
   - C. The dates on which they were sent,
   - D. Records evidencing the calculation methods used therein, and
   - E. Substantiation of the determination of liquid vs. illiquid fund.

III. For the annual audited financial statements, advisers should retain:
   - A. The statements themselves,
   - B. The addresses of investors to which the statements were sent,
   - C. The dates on which they were sent, and
   - D. Documentation of the steps taken to cause an audit if not in a control relationship.

IV. For adviser-led secondary transactions, advisers should retain:
   - A. The opinions and summary of relationships,
   - B. The addresses of investors to which the opinions and summaries were sent,
   - C. The dates on which they were sent, and
   - D. Documentation of the steps taken to cause an audit if not in a control relationship.

V. For prohibited activities, advisers should retain:
   - A. Books and records to document compliance with disclosure and consent requirements,
   - B. The addresses of investors to which disclosures and consent requests were sent, and
   - C. The dates on which they were sent.

VI. For information about preferential treatment, advisers should retain:
   - A. Notices to investors,
   - B. The addresses of investors to which the notices were sent, and
   - C. The dates on which they were sent.

VII. Advisers are required to document in writing the required annual review of their compliance policies and procedures and should consider:
   - A. Any compliance matters that arose during the previous year,
   - B. Any changes in the business activities of the adviser or its affiliates, and
   - C. Any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies and procedures.

The rule does not enumerate specific elements that advisers must include in the written documentation of their annual review. For example, some advisers may review the adequacy of their compliance policies and procedures (or a subset of those compliance policies and procedures) and the effectiveness of their implementation on a quarterly basis. In such a case, the written documentation of the annual review could comprise written quarterly reports.

What are the requirements that impact all private fund advisers?

Note: The prohibited activities and preferential treatment rules will not apply with respect to non-U.S. private fund clients of an SEC-registered (or unregistered) offshore adviser (regardless of whether they have U.S. investors).

Prohibited Activities

I. An adviser to a private fund may not charge or allocate fees or expenses to the private fund if related to:
   A. The adviser's examination, compliance, and other regulatory activities, unless such fees and expenses are disclosed to investors (but without a requirement that investors consent to such charges);
   B. A governmental or regulatory investigation of the adviser unless there is disclosure to, *and* consent from, fund investors;
   C. 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 (*with no exception for disclosure and consent*); or
   D. Underperforming services (*with no exception for disclosure and consent* since failure to perform services was already inconsistent with an adviser's fiduciary duty).

II. Disclosure must be made to all fund investors. Consent means consent from a majority of investors unrelated to the adviser or its related people unless the fund's governing documents establish a higher threshold.

III. The amount of an adviser clawback may not be reduced by the amount of actual, potential, or hypothetical taxes (applicable to the adviser, its related persons or their respective owners or interest holders), *unless the adviser discloses the pre-tax and post-tax amount of the clawback to investors*.

IV. Fees or expenses (to certain private funds) related to a portfolio investment may not be charged or allocated *on a non-pro rata basis* when multiple private funds and other clients are invested in the same portfolio investment, *unless:*
   A. The allocation approach is fair and equitable, and
   B. The adviser distributes advance written notice of the non-pro rata charge and a description of how the allocation approach is fair and equitable under the circumstances; and

V. An adviser may not borrow or receive an extension of credit from a private fund client *without*

disclosure to, and consent from, fund investors.

Preferential Treatment

I. Certain preferential terms are allowed when:
   A. Material economic terms are disclosed in advance of an investor's investment in the private fund.
   B. All other terms are disclosed after the investor's investment.

II. How much *detail* needs to be disclosed? It is not sufficient to disclose that some investors are paying lower fees. You will need to disclose:
   A. The applicable rate or rates, and
   B. The criteria for receiving the applicable rates (including the amount of commitment required).

III. Notwithstanding the above, there is a ban on preferential terms regarding:
   C. **Redemptions** from the fund, *unless*:
      i. No reasonable expectation of a material, negative effect on other investors (e.g., not a situation where a majority of the portfolio investments are illiquid),
      ii. The ability to redeem is required by applicable law, *OR*
      iii. The adviser offers the preferential redemption rights to *all* other investors *without qualification* (i.e., no commitment size, affiliation requirements, or other limitations).
   D. **Preferential information about portfolio holdings or exposures**, *unless*:
      i. No reasonable expectation of a material, negative effect on other investors, *OR*
      ii. The preferential information is offered to *all* investors at substantially the same time.

What are the compliance dates?

I. For compliance with the new required annual audits and the quarterly statements, the compliance date will be 18 months after the date of publication in the Federal Register (publication is pending as of September 14, 2023).

II. For the new rules related to opinions and summaries of the adviser-led secondaries rule, preferential treatment and prohibited activities (each as described below), the compliance dates are:
   A. For advisers with $1.5 billion or more in private funds assets under management, 12 months after the date of publication in the Federal Register; and
   B. For advisers with less than $1.5 billion in private funds assets under management, 18 months after the date of publication in the Federal Register.

III. Compliance with the amended Advisers Act compliance rule (i.e., the annual compliance review) will be required 60 days after publication in the Federal Register.

IV. Legacy status is being provided with respect to:
   A. The prohibition parts of the new rules on Preferential Treatment, and
   B. Investor consents parts of the new rule on the Prohibited Activities.

This means no changes are required of funds or advisers to comply with those aspects of the new rules if the funds commenced bona fide operations as of the compliance date of the rules. However, such legacy status does not permit advisers to charge for 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 Act or the rules promulgated thereunder.[vii]

What should I do now?

Determine whether you are a private fund adviser (registered or unregistered). You are a private fund adviser if you are a person that, for compensation, engages in the business of providing investment advice to privately offered investment vehicles that pool capital from one or more investors and invest in securities and other investments. You are a registered adviser if you are registered as an investment adviser with the SEC using the full Form ADV.

If you are a private fund adviser ...

The new rules described above will be applicable to you. Please consider reaching out to Nixon Peabody LLP to learn about our internally developed checklist that can be used to ensure processes and policies are updated accordingly to account for these rule changes. It is very likely that both funds already in existence and newly planned funds will need to prepare disclosures for compliance with the new rule.

For example, adviser policies, as well as LPA and other governing documents of a fund, would be reviewed to ensure compliance with the Restricted Activities Rules that impacts all private fund advisers. In addition, fund formation and maintenance processes would be reviewed to ensure the proper disclosures are made under the new rules.

If you are an investor in private funds ...

Please consider reaching out to Nixon Peabody LLP to learn how the disclosure of certain preferential terms with private fund advisers may impact your business.

We are further considering the changes from the SEC and will prepare more guidance as challenges to the rule or client inquiries develop. Subscribe here and stay tuned for any new updates that we publish.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

John P. Beals
617.345.1060
jbeals@nixonpeabody.com

Matthew Bobrow
212.940.3730
mbobrow@nixonpeabody.com

William E. Kelly
617.345.1195
wkelly@nixonpeabody.com

Benedict Kwon
213.629.6164
bkwon@nixonpeabody.com

John C. Partigan
202.585.8535
jpartigan@nixonpeabody.com

Todd Tidgewell
518.427.2705
ttidgewell@nixonpeabody.com

Marc Zhang
312.977.4483
mzhang@nixonpeabody.com

---

[i] "IRR" means "Internal Rate of Return" or the discount rate that causes the net present value of all cash flows throughout the life of the private fund to be equal to zero. Cash flows will be represented by capital contributions (i.e., cash inflows) and fund distributions (i.e., cash outflows), and the unrealized value of the fund will be represented by a fund distribution (i.e., a cash outflow). This definition provides investors with a time-adjusted return that takes into account the size and timing of a fund's cash flows and its unrealized value at the time of calculation.

[ii] "MOIC" means "Multiple of Invested Capital" or (i) the sum of: (A) the unrealized value of the illiquid fund and (B) the value of all distributions made by the illiquid fund; (ii) divided by the total capital contributed to the illiquid fund by its investors. This definition provides investors with a measure of the fund's aggregate value (i.e., the sum of clauses (i)(A) and (i)(B)) relative to the capital invested (i.e., clause (ii)) as of the end of the applicable reporting period, as proposed. Unlike the definition of IRR, the MOIC definition does not take into account the amount of time it takes for a fund to generate a return (meaning that the MOIC measure focuses on "how much" rather than "when").

[iii] For the net IRR/MOIC calculations, unrealized performance is not required. The quarterly statement should (i) disclose the assumptions used in making the calculations, such as the rate of fees used and whether blended rates are used to factor in any discounts on fees, and (ii) reference the applicable sections of the fund documents that describe the methodology for calculating fees.

[iv] Consistent with Form ADV and Form PF, related persons here include (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser. "Control" is defined to mean the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.

[v] The quarterly disclosure requirements in respect of fund of funds are complex and will be discussed in greater detail in a separate article.

[vi] "Audit" under Regulation S-X means, with respect to non-registered issuers, an examination of the financial statements by an independent accountant in accordance with either the standards of the PCAOB or U.S. generally accepted auditing standards (U.S. GAAS) as specified or permitted in the regulations and forms applicable to those entities for the purpose of expressing an opinion thereon.

[vii] In the proposed rules, the SEC considered prohibiting exculpation and indemnification related to an adviser's negligent conduct. In the final rules, the SEC did not adopt this prohibition because the SEC determined that the provision was not needed to address the problem. The SEC noted that the federal fiduciary duty applicable to advisers imposed a negligence standard on advisers and that an adviser could not seek exculpation or indemnification for breaching the federal fiduciary duty because such an exculpation or indemnification would be tantamount to a waiver of the federal fiduciary duty. The SEC's viewpoint that the negligence standard has continuously applied to advisers may suggest that modifications to fund documents may be necessary. This will be discussed more fully in a separate article.