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Headlines from the SEC's Private Fund Adviser Reforms

SEC registered investment advisers will face the biggest changes

On August 23, the SEC voted to adopt final amendments to the Investment Advisers Act of 1940 that subject private fund advisers to a number of new requirements. The Rules also include an amendment to existing Rule 206(4)-7 under the Advisers Act that will require all registered investment advisers to document the results of their required annual compliance reviews in writing.

The final Private Fund Adviser Rules are divided into six distinct parts:

1. Written Annual Compliance Review
2. Quarterly Statement Rule
3. Mandatory Annual Audit
4. Adviser-led Secondaries Rule
5. Restricted Activities Rule
6. Preferential Treatment Rule

Highlights

Key items from the reforms that will affect only full SEC registrants (not Exempt Reporting Advisers) are set out below:

- Quarterly Statement Rule: a detailed quarterly statement requirement that includes the following information:
  - for illiquid funds: performance information with and without the impact of "subscription facilities"
  - for illiquid funds: 10 year track record
- Mandatory Annual Audit: an annual audit for each private fund managed by the adviser
- Adviser-led Secondaries Rule: fairness opinions OR valuation opinions for all adviser-led secondary transactions
  - provide a summary of any business relationships and the valuation opinion to investors before they are offered participation in the secondary transaction
- written documentation of the annual review currently required by the Advisers Act.

Exempt Reporting Advisers AND Registered Advisers will face the following changes:

- new prohibited fees including:
  - fees related to an investigation of the adviser unless BOTH disclosure AND consent are achieved from the investors
  - fees related to a sanction resulting from an investigation under any circumstances
  - regulatory examination or compliance fees and expenses (even when service providers are law firms or attorneys) unless disclosure is provided to investors
  - reduction of an adviser clawback by the amount of certain taxes
  - charging fees or expenses for a particular investment on a non-pro rata basis UNLESS the fee approach is fair and equitable and the adviser distributes a written notice of the non-pro rata fees and how it is fair and equitable
  - borrowing or receiving credit from a private fund client
- preferential treatment prohibition
  - preferential redemption terms unless required by law (or given to all investors)
  - information about portfolio holdings unless given to all investors
  - preferential treatment generally, unless disclosed to all investors
- legacy status is important to note, particularly for the preferential treatment pieces – had the SEC failed to offer this piece, offering documents would have required re-writes across the board to account for the preferential treatment and fee pieces.

Important insights from the adopting release

We have summarized below the areas that the SEC takes issue with regarding the current private fund operating environment:

Lack of transparency: the SEC frequently takes issue with this during examinations. The SEC explicitly states here that they believe that lack of full transparency for all investors regarding a fund's operating environment, including fees, expenses and arrangements with individual investors, harms investors in private funds. Even prior to this new set of rules, the SEC had a range of evidence with which to pursue advisors for this lack of transparency. In theory, the Adviser's Act already requires advisers to disclose any items that are material to an investors decision to invest in a private fund. Offering Memoranda and the ADV part II typically satisfied this criteria.

Conflicts of interest: again, the SEC had a range of evidence to pursue a private fund adviser for conflicts of interest that were undisclosed even prior to this rulemaking. The ADV itself requires full disclosure of an adviser's conflicts, however, the SEC carried out a significant amount of work to the rules to help ensure that they could win cases without frequent court visits, if they believed that an adviser had an undisclosed conflict. They may have succeeded here, however, they were already drawing significant attention to this point during examinations.

Much relief from the worst: we saw a lot of relief from the worst possible outcomes. The industry lobbying efforts against ideas about strict liability have clearly been successful.

The adopting release and SEC fact sheet can be found here.

Effective and compliance dates

The New Rules will take effect 60 days after publication in the Federal Register (Effective Date) which was September 14, 2023, however, the SEC's interpretations regarding how an adviser's fiduciary duty applies to its private fund clients (as discussed in the Restricted Activities Rule section above) are effective immediately.

Compliance with the amendments to the Compliance Rule is required on the Effective Date - November 13, 2023.

Compliance with the (1.) Restricted Activities Rule, (2.) Preferential Treatment Rule and (3.) Adviser-Led Secondaries Rule will be required within 12 months of the Effective Date for advisers with $1.5 billion or more in private fund assets under management (September 14, 2024) and within 18 months of the Effective Date for advisers with less than $1.5 billion in private fund assets under management (March 14, 2025).

Compliance with the (4.) Quarterly Statement Rule and (5.) Audit Rule will be required within 18 months after the Effective Date (March 14, 2025).

How can Waystone Compliance Solutions help?

Our team of US compliance professionals are experts at managing SEC regulatory compliance programs, providing clear insight into how to meet the challenges of this complex rule.

If you would like more information on this topic or have any questions, please reach out to our US Compliance Solutions team today.