

# Private Fund Adviser Reforms: **Who, What, and When**

In August 2023, the SEC adopted five rules that apply to advisers to private funds and one rule that applies to all registered investment advisers. This package has something for everyone. Rules that apply only to SEC registered private fund advisers; rules for all advisers to private funds, including ERAs; and a rule for ALL SEC registrants, whether you manage a private fund or not.

This guide provides a detailed overview of the **What** (the rules), the **Who** (who is affected by each rule), and the **When** (associated compliance dates for the rules).

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# Who

**All investment advisers managing private funds** must follow the **Preferential Treatment Rule** and the **Restricted Activities Rule**. This means that an Exempt Reporting Adviser (ERA) that only manages a single private fund must still follow the Preferential Treatment Rule and the Restricted Activities Rule and prepare for the compliance deadline.

**SEC registrants managing private funds** must also follow the **Quarterly Statement Rule, Mandatory Private Fund Audit Rule**, and the **Adviser-Led Secondaries Rule**. Since growth in AUM can require an unregistered firm to become an SEC Registrant, all firms managing private funds should familiarize themselves with these new rules and prepare for compliance as necessary. The Quarterly Statement Rule will require the most work in advance.

**All SEC Registrants** must follow the **Written Annual Review Rule**, regardless of whether they manage private funds. As soon as your firm becomes an SEC registrant, your compliance program must be up and running. Your most recent, written annual review will be among the first requests during an SEC Exam.

# What

## Preferential Treatment

The Preferential Treatment Rule prohibits any adviser managing private funds from directly or indirectly granting preferential treatment to investors in a private fund or in a similar pool of assets without meeting an exception and delivering written notice.

**Redemption** – Granting the ability to redeem interest on terms the adviser expects to have a material negative effect on other investors is prohibited, unless:

- Required by Law Exception – If preferential treatment is required by state or federal law, such as a forced redemption due to a violation of the pay to play rule by the adviser, then it is permitted with written notice.
- Redemption Terms Offered to All Investors – If the preferential redemption or liquidity terms are offered to all investors, then the terms are permitted with written notice.
- Legacy Status – See below.

**Information** – Providing information on portfolio holdings or exposures of a private fund or a similar pool of assets that the adviser expects to have a material negative effect on other investors is prohibited, unless:

- Information offered to all investors – If the information is offered to all existing investors in the fund and any similar pool of assets at substantially the same time, then the terms are permitted with written notice.
- Legacy Status – See below.

**All Preferential Treatment** – All direct and indirect preferential treatment is prohibited unless the adviser provides written notice.

**Written notice** – Timing of written notice depends on whether the preferential treatment relates to material economic terms or not and whether the fund is illiquid or liquid. This means certain terms must be delivered in writing to prospective investors pre-commitment. Written notice must be sent as soon as practicable to investors in illiquid funds following the end of the fundraising period and to investors in liquid funds following their investment in the private fund. For all current investors, written notice of preferential treatment provided by the adviser or its related person since the last written notice must be delivered at least annually.

**Legacy Status** – The rule allows grandfathering for certain treatment by granting legacy status. Legacy status is available for preferential redemption terms and preferential information sharing where the fund has commenced operations and entered into written agreements prior to the compliance deadline, and where the parties would have to amend such governing agreements due to the rule. Legacy status is not available for other forms of preferential treatment. Even if a fund has legacy status, written notice disclosing preferential treatment to fund investors is still required.

**Putting it all together** – Advisers should review governing documents and current practices to see what preferential treatment exists and whether legacy status applies. Decide on ending any current practices or pursuing compliance under the rule. Look at fund structures and similar pools of assets to determine what investors are on the notice list for your funds. Gather input from managers, investor relations, and legal counsel on how best to disclose preferential treatment as required. Develop written notices for all preferential treatment needing disclosure. This includes disclosing all preferential side-letter terms to fund investors. Prepare to update governing document and policies and procedures for the new rule.

## Restricted Activities

The Restricted Activities Rule prohibits any adviser managing private funds from directly or indirectly doing any of the following five activities without meeting an exception.

**Charging Investigation Costs** – An adviser may not charge or allocate to a private fund fees or expenses due to an investigation by a governmental or regulatory authority, unless:

- Written Consent – The adviser requests each investor to consent to the charge or allocation and receives at least a majority in interest of the investors that are not related persons of the adviser.
- Legacy Status – See below.

**Exception:** Never for a Sanction – An adviser may not charge or allocate fees or expenses from an investigation that resulted in a sanction for a violation of the Advisers Act.

**Charging Examination Costs** – An adviser may not charge or allocate to a private fund fees or expenses due to an examination of the adviser or its related persons, unless:

- Written Notice – The adviser distributes written notice to all investors of such fees or expenses, including the dollar amount, within 45 days after the end of the quarter in which the charge occurred.

**Reducing Clawbacks for Taxes** - An adviser may not reduce the amount of an adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, unless:

- Written Notice – The adviser distributes written notice to all investors with the aggregate dollar amounts of the adviser clawback before and after any reduction for taxes within 45 days after the end of the quarter in which the adviser clawback occurred.

**Non-Pro Rata Allocations** - An adviser may not charge or allocate fees or expenses related to a portfolio investment on a non-pro rata basis when multiple funds and other clients advised by the adviser have invested in the same portfolio investment, unless:

- Fairness and Written Notice – The charge or allocation is fair and equitable under the circumstances, and prior to the charge the adviser distributes written notice of the charge, along with a description of how it is fair and equitable.

**Borrowing from a Fund** - An adviser may not borrow assets nor receive a loan or extension of credit from a private fund client unless:

- Written Consent and Notice – The adviser distributes written notice to all investors of the material terms of the borrowing, loan, or extension of credit; requests consent from each investor; and obtains written consent from at least a majority in interest of the investors that are not related persons of the adviser.
- Legacy Status – See below.

**Legacy Status** – The rule allows grandfathering by granting legacy status for two of the restricted activities: Charging Investigation Costs and Borrowing from Fund. Legacy status is available for these two activities where the fund has commenced operations and entered into written agreements prior to the compliance deadline, and where the parties would have to amend such governing agreements due to the rule. However, advisers may not charge or allocate fees or expenses from an investigation that resulted in a sanction, regardless of legacy status. Legacy status is not available for other restricted activities.

**Putting it all together** – Advisers should review governing documents and current practices to see what restricted activities exist and whether legacy status applies. Look at existing disclosure of any such activities and develop compliant written notices and procedures for obtaining consent where needed. Decide on any activities that need to end. Prepare to update governing documents and policies and procedures for the new rule. Pay close attention to charges and allocations for investigations and examinations and note any current charges and allocations that may become violations of the rule if a sanction is given.

## Quarterly Statement Rule

The Quarterly Statement Rule requires SEC Registrants managing a private fund with at least two quarters of operating results to distribute quarterly statements to the private fund's investors. These quarterly statements must contain the following:

**Fund Table** – The Quarterly Statement must present a fund table with (1) all compensation fees or other amounts paid or allocated to the adviser, (2) all other fees and expenses allocated to or paid by the fund, and (3) the amount of any offsets or rebates carried forward during the reporting period. Fees and expenses must be presented both before and after offsets, rebates, or waivers. SEC staff prohibited the use of “miscellaneous” line items or other broad categories. Fees and expenses must be broken out into specific line items.

**Portfolio Investment Table** - The Quarterly Statement must present a portfolio investment table that discloses investment compensation to the adviser or its related persons, both before and after any offsets, rebates or waivers, with separate line items for each category.

**Calculations and Cross-References** - The Quarterly Statement must include prominent disclosure regarding the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated and include cross references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.

**Performance** - The Quarterly Statement must include a presentation of performance. Advisers must determine whether each fund is liquid or illiquid, document this determination, and present the following:

- **Liquid Funds** – For liquid funds, annual net total returns for each fiscal year over the past 10 fiscal years or since inception must be presented, whichever is shorter, along with average annual net total returns over 1, 5, and 10 year periods. Also, cumulative net total returns for the current fiscal year as of the end of the most recent fiscal quarter covered by the Quarterly Statement.
- **Illiquid Funds** – For illiquid funds, the following performance measures must be shown since inception to the end of the quarter covered by the Quarterly Statement (or most practicable date) and shown with and without the impact of any fund-level subscriptions facilities: Net and Gross IRR for the illiquid fund, Net and Gross MOIC for the illiquid fund, Gross IRR and Gross MOIC for the realized and unrealized portions of the illiquid fund's portfolio with realized and unrealized performance shown separately. Lastly, a statement of contributions and distributions for the illiquid fund must be presented.

**Other matters** – Performance presentations must include the date as of which the performance is current and prominent disclosures of the criteria and assumptions made in calculating the performance.

**Consolidated Reporting** - To the extent it would provide more meaningful information to the investors and would not be misleading, the adviser must consolidate the required reporting to cover similar pools of assets.

**Putting it all together** – The Quarterly Statement Rule is likely to require the most preparation work for SEC Registrants. Start immediately by reviewing existing investor reporting and mapping out remaining needs for a compliant Quarterly Statement. Review existing language on fee, expense, and performance calculation to complete the calculation disclosures and cross-references in the Quarterly Statement. Develop methodology for calculating any new performance measures and make sure software and systems can be maintained to complete these measures within the required timeframe for distribution under the Rule. Consider investor relations, how information sharing will change, and what sort of outreach may be necessary ahead of the first Quarterly Statement. Look to third-party service providers to help develop your procedure for completion and delivery. All SEC Registrants have the same compliance deadline because the SEC staff recognize the amount of work the Rule will require. Start preparing now.

## Mandatory Private Fund Adviser Audits

The Mandatory Private Fund Adviser Audit Rule requires SEC Registrants managing private funds to make sure each fund they control undergoes a financial statement audit that ends with delivery of audited financial statements. If an adviser provides investment advice to a fund it does not control, the adviser may not provide investment advice unless it takes all reasonable steps to cause the fund to undergo an audit and deliver audited financial statements.

**End of Surprise Audit for Private Funds** - SEC staff indicated their intention to eliminate the ability for private funds to meet the Custody Rule through a surprise examination. Instead, all funds must undergo a financial statement audit under the Custody Rule, with an independent public accountant registered with the PCAOB, that meets the definition of Regulation S-X, prepared in accordance with generally accepted accounting principles (GAAP), and delivered to investors annually within 120 days of the fiscal year-end or promptly upon liquidation.

**No Waivers for “Stub Periods”** – SEC staff were not swayed by comments to waive the requirement for newly opened funds or funds winding down to liquidation. Instead, the Mandatory Private Fund Adviser Audit Rule aims to be aligned with the Custody Rule and an annual audit would be required under current law. The rulemaking proposal for the Safeguarding Rule was reopened to public comment for this issue, so relief may come with a final Safeguarding Rule.

**Putting it all together** – SEC Registrants should review their exposure, both for the funds they manage and any funds to which they provide investment advice. Arrange for financial statement audits for all funds, and look out for stub periods that need an initial or final annual audit. For any arrangements to provide investment advice to funds controlled by another, take all reasonable steps to cause such fund to undergo a compliant audit.

## Adviser-Led Secondaries

The Adviser-Lead Secondaries Rule requires SEC Registrants managing private funds to obtain a fairness opinion or a valuation opinion in connection with an adviser-led secondary transaction from an independent opinion provider. The adviser will also be required to prepare a summary of any material business relationships the independent opinion provider has had with the adviser or any of its related persons, within the past two years, and distribute such summary to investors prior to the due date of the election form.

**Scope** – Adviser-led secondary transactions are defined as transactions initiated by the adviser or any related persons that offer investors the choice between (1) selling all or a portion of their interest in the private fund and (2) converting or exchanging all or a portion of their interests in the private fund for interest in another vehicle advised by the adviser or any of its related persons.

**Fairness Opinion** – A fairness opinion is a written opinion stating that the price being offered to the private fund for any assets being sold as part of the adviser-led secondary transaction is fair.

**Valuation Opinion** – A valuation opinion is a written opinion stating the value, as a single amount or a range, of any assets being sold.

**Summary of Material Business Relationships** – Summaries must have a two-year lookback from the date of the opinion. Whether a business relationship is material is a facts and circumstances test. Audit, consulting, capital raising, investment banking, and other similar services would typically be material business relationships.

**Putting it all together** – SEC Registrants planning adviser-led secondary transactions should build in extra time for the necessary requirements of the Adviser-Lead Secondaries Rule. Deciding on the type of opinion to obtain, engaging an independent opinion provider and writing a summary of material business relationships for that provider in time for delivery ahead of the election form due date could delay an adviser that had not prepared for the Rule in advance.

## Written Annual Review

All SEC Registrants must document the annual review of their compliance policies and procedures in writing to comply with this amendment to the Advisers Act. The annual review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the adviser's policies and procedures. SEC staff pointed to three reasons why written annual reviews were necessary (1) to help advisers assess needed changes, (2) to allow the SEC to determine if the adviser was regularly reviewing its policies and procedures, and (3) have documentation for client and investor due diligence to speak to the adviser's compliance program.

- **Client Due Diligence** - The SEC staff may have encouraged due diligence requests when they said "clients and investors conducting due diligence may request written documentation of the annual review to assess whether the adviser applies a structured framework and rigor to its compliance program." This requirement may cement the annual review as a common request item.
- **Prompt Production to Examiners** – Regarding "prompt" production upon request, the adopting release quoted past guidance of electronic recordkeeping under the Adviser's Act: "we expect that a fund or adviser would be permitted to delay furnishing electronically stored records for more than 24 hours only in unusual circumstances. At the same time, we believe that in many cases funds and advisers could, and therefore will be required to, furnish records immediately or within a few hours of request."

**Putting it all together** – All SEC Registrants are already in the practice of conducting an annual review. A formal requirement means having that documentation in place and being able to produce it for requests from clients and investors and requests during SEC examinations.

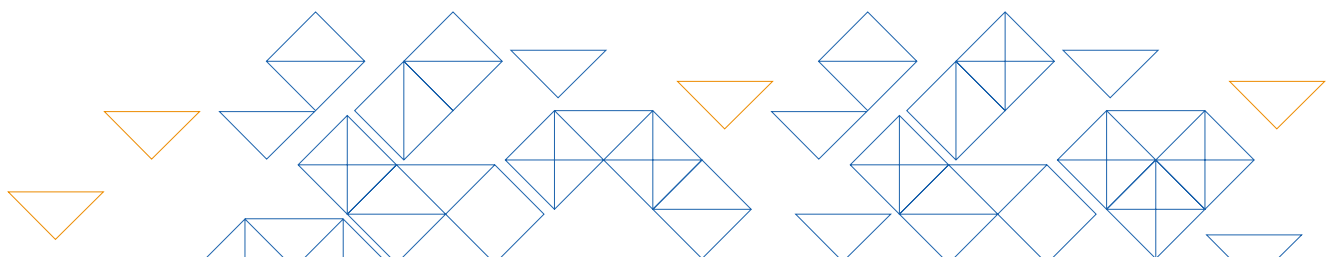
## When

Compliance deadlines are as follows. Note that staggered deadlines based on private fund assets under management exist for some rules.

Larger private fund advisers are firms with more than \$1.5 billion in private fund assets under management as of the most recent fiscal year end.

Smaller private fund advisers are firms with \$1.5 billion or less in private fund assets under management as of the most recent fiscal year end.

- **November 13, 2023** – Compliance date for the **Written Annual Review Rule**
- **September 14, 2024** – Larger Private Fund Adviser compliance date for the **Restricted Activities Rule**, the **Adviser-Led Secondaries Rule**, and the **Preferential Treatment Rule**.
- **March 14, 2025** – Compliance date for the **Quarterly Statement Rule** and the **Mandatory Private Fund Audit Rule**. Smaller Private Fund Adviser compliance date for the **Restricted Activities Rule**, the **Adviser-Led Secondaries Rule**, and the **Preferential Treatment Rule**.



## About Fairview

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