

Private Fund Adviser Reforms: Final Rules



The Securities and Exchange Commission adopted new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act) to enhance the regulation of private fund advisers. The new rules require private fund advisers registered with the Commission to:

- Provide investors with quarterly statements detailing information regarding private fund performance, fees, and expenses;
- Obtain an annual audit for each private fund; and
- Obtain a fairness opinion or valuation opinion in connection with an adviser-led secondary transaction.

The new rules require that all private fund advisers:

- Prohibit engaging in certain activities and practices that are contrary to the public interest and the protection of investors unless they provide certain disclosures to investors, and in some cases, receive investor consent; and
- Prohibit providing certain types of preferential treatment that have a material negative effect on other investors and prohibit other types of preferential treatment unless disclosed to current and prospective investors.

Additionally, the amendments will require all registered advisers, including those that do not advise private funds, to document in writing the annual review of their compliance policies and procedures.

Why this Matters

Private funds and their advisers play an important role in our financial markets, and investment advisers' private fund assets under management have steadily increased over the past decade. Private funds and their advisers also play an increasingly important role in the lives of millions of Americans. Individuals have indirect exposure to private funds through their participation in public and private pension plans, endowments, foundations, and certain other retirement plans.

The Commission is adopting carefully tailored rules to address certain practices that may impose significant risks and harms on investors and private funds. The reforms are designed to protect those who directly or indirectly invest in private funds by increasing visibility into certain practices, establishing requirements to address practices that have the potential to lead to investor harm, and prohibiting or restricting adviser activity that is contrary to the public interest and the protection of investors.

What's Required

For Registered Private Fund Advisers:

Quarterly Statement Rule. The reforms require registered private fund advisers to distribute a quarterly statement to private fund investors. The statement must disclose fund-level information regarding performance, the cost of investing in the private fund, fees and expenses paid by the private fund, as well as certain compensation and other amounts paid to the adviser.

Private Fund Audit Rule. The reforms require registered private fund advisers to cause the private funds they advise to undergo a financial statement audit that meets the requirements of the audit provision in the Advisers Act custody rule (rule 206(4)-2)). These audits will provide an important check on the adviser's valuation of private fund assets and protect private fund investors against the misappropriation of fund assets.

Adviser-Led Secondaries Rule. The reforms require a registered private fund adviser to obtain a fairness opinion or a valuation opinion 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. The rule also requires the adviser to prepare and distribute to the private fund's investors a summary of any material business relationships the adviser has, or has had within the prior two years, with the independent opinion provider. This requirement will provide a check against an adviser's conflicts of interest in structuring and leading such transactions.

Books and Records Rule Amendments. To facilitate the Commission's ability to assess an adviser's compliance with the rules, the reforms include amendments to the books and records rule under the Advisers Act for registered private fund advisers.

For All Private Fund Advisers:

Restricted Activities Rule. To address certain conflicts of interest that have the potential to lead to investor harm, the reforms include a new rule that restricts all private fund advisers from engaging in the following activities that are contrary to the public interest and the protection of investors:

- Charging or allocating to the private fund fees or expenses associated with an investigation of the adviser without disclosure and consent from fund investors. Further, an adviser may not charge 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;
- Charging or allocating to the private fund regulatory, examination, or compliance fees or expenses of the adviser, unless such fees and expenses are disclosed to investors;
- Reducing the amount of an adviser clawback by the amount of certain taxes, unless the adviser discloses the pre-tax and post-tax amount of the clawback to investors;

- Charging or allocating fees or expenses related to a portfolio investment on a non-pro rata basis, unless the allocation approach is fair and equitable and 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
- Borrowing or receiving an extension of credit from a private fund client without disclosure to, and consent from, fund investors.

Preferential Treatment Rule. To address the material, negative effects of specific types of preferential treatment on other investors, the reforms prohibit all private fund advisers from providing preferential terms to investors regarding: a) certain redemptions from the fund, unless the ability to redeem is required by applicable law or the adviser offers the preferential redemption rights to all other investors without qualification; and b) certain preferential information about portfolio holdings or exposures, unless such preferential information is offered to all investors. In addition, this rule prohibits all private fund advisers from providing preferential treatment to investors, unless certain terms are disclosed in advance of an investor's investment in the private fund and all terms are disclosed after the investor's investment.

Legacy Status. The Commission is providing legacy status for the prohibitions aspect of the Preferential Treatment Rule and the aspects of the Restricted Activities Rule that require investor consent. The legacy status provisions apply to governing agreements that were entered into prior to the compliance date if the applicable rule would require the parties to amend the agreements.

For All Registered Advisers:

Compliance Rule Amendments. The reforms include amendments to the compliance rule under the Advisers Act requiring all registered advisers, including those that do not advise private funds, to document in writing the required annual review of their compliance policies and procedures. Written documentation of the annual review will help the Commission to determine advisers' compliance with the rules and identify potential compliance program weaknesses.

The Quarterly Statement Rule, Private Fund Audit Rule, Adviser-Led Secondaries Rule, Restricted Activities Rule, and Preferential Treatment Rule do not apply to investment advisers with respect to securitized asset funds they advise.

What's Next

For the Private Fund Audit Rule and the Quarterly Statement Rule, the compliance date will be 18 months after the date of publication in the Federal Register. For the Adviser-Led Secondaries Rule, the Preferential Treatment Rule, and the Restricted Activities Rule, the compliance dates are: 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 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. Compliance with the amended Advisers Act compliance rule will be required 60 days after publication in the Federal Register.