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Investment Management Update

September 2023

SEC Adopts New Rules for Private Fund Advisers

Key Notes:

- The SEC has adopted new rules under the Investment Advisers Act of 1940 that aim to protect private fund investors by increasing visibility into certain private fund adviser practices.
- Reforms include quarterly reporting requirements, increased transparency regarding side letters and other "preferential treatment," prohibitions on certain liquidity rights and information sharing.

On August 23, the SEC issued Release No. IA-6383, adopting new rules for private fund advisers under the Investment Advisers Act of 1940, as amended. The new rules aim to protect private fund investors by increasing visibility into certain private fund adviser practices and consist of five sets of regulations and prohibitions:

- Restricted Activities Rule
- Preferential Treatment Rule
- Quarterly Statement Rule
- Audit Rule
- Adviser-Led Secondary Rule

The Restricted Activities and Preferential Treatment Rules notably apply to all investment advisers, including those not registered with the SEC.

Restricted Activities Rule

The Restricted Activities Rule (Rule 211(h)(2)-1) prohibits all private fund advisers, including those who are not SEC-registered, from engaging in certain activities unless they satisfy specific disclosure and consent requirements. The rule prohibits outright charging or allocating investigation expenses resulting in a sanction.

The rule permits the fair and equitable non-pro-rata allocation or charging of fees with advance notice to investors of the charge and a description of how the allocation is fair and equitable under the circumstances.

Under the new rule, advisers are required to give after-the-fact disclosure to investors for charging regulatory, compliance or examination expenses and for reducing performance compensation clawback for taxes. Such notice must be in writing and given to investors within 45 days after the end of the quarter in which the relevant activity occurs.

Advisers are now required to obtain informed consent for charging or allocating investigation expenses (not resulting in sanction) and for borrowing or receiving an extension of credit from a client. For such activities, solicitation for informed consent must be sent to all investors and consent must be obtained from at least a majority in interest of investors unrelated to the adviser. Approval from fund governance bodies such as an advisory committee, by itself, is deemed insufficient.

Contractual arrangements for an adviser to borrow from a private fund or to charge certain investigation fees and expenses are subject to legacy status. Accordingly, the rule does not apply to such agreements when the fund has commenced operations as of the compliance date, the agreement was entered into prior to the compliance date,

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and the rule, if applied, would require the parties to amend such agreement.

Preferential Treatment Rule

The Preferential Treatment Rule (Rule 211(h)(2)-3) prohibits all private fund advisers, including those that are not SEC-registered, from either providing preferential redemption terms or providing certain information to an investor in a private fund or “similar pool of assets” if the adviser believes it would have a material negative effect on other investors in that fund. The rule also requires advance disclosure of any preferential treatment related to material economic terms and subsequent disclosure of other preferential terms.

Legacy status is available for the rule’s prohibition on preferential redemption or information rights, meaning an existing agreement that grants such preferential rights is exempt from the rule, provided it was entered into prior to the compliance date and would require amendment to comply with the rule.

The prohibition on preferential redemption terms does not apply if the investor is required to redeem due to applicable laws, rules, regulations or the order of a relevant government body; or if the adviser has offered the same redemption terms to all future investors. The second exception does not require that all investors have identical redemption rights, only that they be offered the same rights. However, the alternatives must be offered without qualification (such as minimum commitment size or affiliation with the adviser).

The preferential treatment prohibitions apply to the granting of preferential terms to certain investors in a private fund or a “similar pool of assets,” defined as another pooled investment vehicle with “substantially similar investment policies, objectives, or strategies” as the private fund. Whether a pool of assets managed by an adviser is a similar pool of assets to a private fund is a facts-and-circumstances test, but the SEC notes the term’s broad scope and that it could capture an adviser’s funds with a different sector or geographical focus.

Other preferential treatment of investors is permitted under the rule provided the preferential treatment is disclosed in a written notice to prospective and current investors. Such disclosures do not need to adhere to a particular form but must specifically describe the preferential treatment to convey its relevance. Any preferential treatment relating to material economic terms must be disclosed to each prospective investor prior to their investment in the fund, and all preferential treatment (including that unrelated to material economic terms) must be disclosed to other investors as soon as reasonably practicable after their investment in the fund (for liquid funds) or as soon as reasonably practicable after the fundraising period (for illiquid funds).

Quarterly Statement Rule

The Quarterly Statement Rule (Rule 211(h)(1)-2) requires all SEC-registered investment advisers to prepare a quarterly statement including certain information regarding fees, expenses and performance for each private fund they advise. Consolidated reporting for similar pools of assets is required to the extent it would provide more meaningful information to the private fund’s investors and is not misleading.

Such quarterly statements are generally required within 45 days after the first three quarters and 90 days after the end of each fiscal year. Fund-of-funds statements must be distributed within 75 days after the first three quarters and 120 days after the end of the fiscal year.

Audit Rule

The Audit Rule (Rule 206(4)-2) requires all SEC-registered investment advisers to obtain an annual financial statement audit of the private funds they advise and deliver audited financial statements to investors within 120 days of the end of the fiscal year (180 days in the case of a fund of funds). Any such audit must be performed annually by an independent public accountant registered with and subject to inspection by the Public Company Accounting Oversight Board and in accordance with GAAP or another comprehensive body of accounting standards.

Adviser-Led Secondary Rule

The Adviser-Led Secondary Rule (Rule 211(h)2-2) requires all SEC-registered investment advisers to distribute certain disclosures to investors in connection with any adviser-led secondary transaction. Prior to the due date of the election form for such a transaction, the adviser must deliver to investors a fairness opinion or valuation opinion from an independent opinion provider and a written summary of any material business relationships between the adviser or its related persons and the independent opinion provider within the two-year period immediately prior to the issuance date of the fairness or valuation opinion.

The SEC broadly describes "adviser-led secondary transaction" as any transaction initiated by an adviser or its related persons that offers fund investors the option between selling all or a portion of their interests in the private fund and converting or exchanging them for new interests in another vehicle advised by the adviser or any of its related persons. Tender offers and secondary transactions assisted by the adviser at the unsolicited request of the investor are not considered adviser-led secondary transactions.

Annual Compliance Review – 206(4)-7(B)

Each SEC-registered investment adviser is currently required to annually review the adequacy of its compliance policies and procedures. The new rules specify this annual compliance review must be conducted in writing.

Transition Period

The compliance period for the new rules varies depending on the rule and the size of the adviser. The compliance period will begin on November 13, 2023.

- Larger private fund advisers ($1.5 billion or more in AUM) must comply with the Quarterly Statement and Audit Rules by March 14, 2025, and the Adviser-Led Secondary, Preferential Treatment and Restricted Activities Rules by September 14, 2024.
- Smaller private fund advisers (less than $1.5 billion in AUM) must comply with the new rules by March 14, 2025.

All SEC-registered advisers must comply with the new annual compliance review requirements by November 13, 2023 (i.e., for the next annual review occurring after the compliance date).

FOR MORE INFORMATION

For more information, please contact:

Cassandra W. Borchers
513.352.6632
Cassandra.Borchers@ThompsonHine.com

Andrew J. Davalla
614.469.3353
Andrew.Davalla@ThompsonHine.com

Jacob Olliffe
202.263.4156
Jacob.Olliffe@ThompsonHine.com

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