The Before and After of Private Fund Adviser Reform: A Comparison of the Final Rule to the Proposal

August 23, 2023

Earlier today, the Securities and Exchange Commission (the "SEC") adopted final rules applicable to investment advisers to private funds. Amended Rules 204-2 and 206(4)-7, and new Rules 206(4)-10, 211(h)(1)-1, 211(h)(1)-2, 211(h)(2)-1, 211(h)(2)-2, and 211(h)(2)-3 (collectively the "Adopted Rules") usher in a host of new regulatory requirements applicable to private funds unlike any seen before by the industry.

The SEC originally proposed rules applicable to private fund advisers in February 2022 (the "Proposed Rules"). While the SEC appears to have backed away from including in the Adopted Rules some of the most concerning proposals in response to public comments, the Adopted Rules nonetheless impose significant requirements on advisers to private funds. In addition, the absence of certain proposals from the Adopted Rules does not entirely abate industry concerns arising out of the Proposed Rules.

The Adopted Rules cover fee and expense allocations, general partner clawbacks, preferential treatment, adviser-led secondaries, and reporting. In response to industry comments, certain Adopted Rules include limited exceptions for legacy funds that were in existence and commenced operations before the relevant compliance date. The Adopted Rules also create a general exception for securitized asset funds.

The Adopted Rules have varying compliance periods, which will begin when the rules are published in the federal register. The extensive reporting requirements will have the longest compliance period of 18 months, while other compliance periods range from 12–18 months depending on an adviser's assets under management. The new requirement to document annual compliance reviews under amended Rule 206(4)-7 has the shortest compliance period of 60 days.

We have set out below an initial summary of the key differences between the Proposed Rules and the Adopted Rules. We will provide more in-depth analysis of the Adopted Rules in the near future.

RESTRICTED/PROHIBITED ACTIVITIES

Proposed Rule	Proposal Would Have Applied To	Adopted?	Adopted Rule	Adopted Rule Applies To
Limitations of Liability. The Proposed Rules would have prohibited advisers from seeking indemnification or otherwise limiting the adviser's liability for its breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.	All advisers to private funds (including RIAs and ERAs).	No, but see note regarding commentary.	Note: The absence of the prohibition from the Adopted Rules does not entirely abate the concern caused by the Proposed Rule regarding limitations of liability.	N/A
GP Clawbacks. The Proposed Rules would have prohibited advisers from reducing the amount of a GP clawback by taxes (paid or deemed paid).	All advisers to private funds (including RIAs and ERAs).	Yes, but with modifications that effectively eliminate the impact for most advisers.	Adviser may not reduce clawback by the amount of certain taxes, unless the adviser provides written notice of the pre-tax and post-tax dollar amount of the clawback to investors within 45 days after the end of the fiscal quarter in which the clawback occurs.	All advisers to private funds (including RIAs and ERAs).
Adviser Compliance and Related Fees. The Proposed Rules would have prohibited charging a fund for fees or expenses related to an examination or investigation of the adviser or any regulatory or compliance fees or expenses of the adviser or its related persons.	All advisers to private funds (including RIAs and ERAs).	Yes, with modifications.	Adviser (and related person) compliance and examination expenses may be allocated to funds only with written notice including specific dollar amount of expense within 45 days after the end of fiscal quarter in which the charge occurs. Adviser investigation expenses may be allocated to funds with disclosure and consent from majority in interest of	All advisers to private funds (including RIAs and ERAs).

Proposed Rule	Proposal Would Have Applied To	Adopted?	Adopted Rule	Adopted Rule Applies To
			fund investors not related to the adviser. Note: Exception for certain legacy funds applies to investigation expenses if an amendment to the fund's governing documents would be needed to comply. Except that fees or expenses relating to an investigation that results in a sanction under the Advisers Act may not be allocated to a fund.	
Prohibition on Non-Pro Rata Cost Allocations. The Proposed Rules would have prohibited charging a fund for fees or expenses related to portfolio investments on a non-pro rata basis among clients.	All advisers to private funds (including RIAs and ERAs).	Yes, with modifications.	Fees or expenses related to a portfolio investment may be allocated on a non-pro rata basis so long as the allocation approach is fair and equitable and, prior to charging the non-pro rata fee or expense to a private fund, the adviser distributes written notice of the non-pro rata charge and a description of how the allocation approach is fair and equitable under the circumstances to each investor.	All advisers to private funds (including RIAs and ERAs).

Proposed Rule	Proposal Would Have Applied To	Adopted?	Adopted Rule	Adopted Rule Applies To
Prohibition on Borrowings from Private Funds. The Proposed Rules would have prohibited advisers from borrowing or receiving an extension of credit from a private fund client.	All advisers to private funds (including RIAs and ERAs).	Yes, with modifications.	An adviser may borrow or receive an extension of credit from a private fund client only if the adviser provides disclosure of material terms to, and obtains written consent from, a majority in interest of fund investors not related to the adviser. Note: Exception for certain legacy funds applies.	All advisers to private funds (including RIAs and ERAs).
Fees for Services Not Provided. The Proposed Rules would have prohibited charging portfolio companies for services not provided (e.g., accelerated monitoring fees).	All advisers to private funds (including RIAs and ERAs).	No.	Note: The absence of the prohibition from the Adopted Rules does not entirely abate the concern caused by the Proposed Rule fees for services not provided.	N/A.

ADVISER-LED SECONDARIES

Proposed Rule	Proposal Would Have Applied To	Adopted?	Adopted Rule	Adopted Rule Applies To
Fairness Opinion. Proposed rule would have required advisers to obtain and distribute to investors a fairness opinion from an independent opinion provider before closing on an investment in an adviser-led secondary transaction.	Registered investment advisers advising private funds.	Yes, with minor modifications.	Adviser must obtain a fairness opinion or a valuation opinion from an independent opinion provider (i.e., not an affiliate of the adviser).	Registered investment advisers to private funds.

<u>Proposed Rule</u>	<u>Proposal Would Have Applied To</u>	<u>Adopted?</u>	<u>Adopted Rule</u>	<u>Adopted Rule Applies To</u>
Material Business Relationships. Proposed rule would have required advisers to prepare and distribute a written summary to investors of material business relationships between the adviser and the opinion provider in the last two years before closing.	Registered investment advisers advising private funds.	Yes, with no modifications.	Adviser must prepare and distribute to the private fund's investors a summary of any material business relationships that the adviser has, or has had within the prior two years, with the independent opinion provider. Summary must be provided before due date of the election form seeking confirmation from investors of participation in the transaction.	Registered investment advisers to private funds.

PREFERENTIAL TREATMENT

<u>Proposed Rule</u>	<u>Proposal Would Have Applied To</u>	<u>Adopted?</u>	<u>Adopted Rule</u>	<u>Adopted Rule Applies To</u>
Certain Preferential Treatment Prohibited. The Proposed Rule would have prohibited all private fund advisers from providing preferential treatment to certain investors regarding (1) redemptions from the fund or (2) information about portfolio holdings or exposures.	All advisers to private funds (including RIAs and ERAs).	Yes, with modifications.	**(1) Redemptions:** Advisers may not grant an investor in a private fund (or similar pool of assets) the ability to redeem its interest on terms that the <u>adviser reasonably expects to have a material, negative effect</u> on other investors in that private fund or a similar pool of assets, <u>unless the adviser offers the preferential redemption rights to all other investors without qualification or the ability to redeem is required by</u>	All advisers to private funds (including RIAs and ERAs).

Proposed Rule	Proposal Would Have Applied To	Adopted?	Adopted Rule	Adopted Rule Applies To
			applicable law. **(2) Information Rights**: Advisers may not provide information regarding the portfolio or exposure of a private fund or similar pool of assets to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or a similar pool of assets, unless the adviser offers such information to all other existing investors in the fund at substantially the same time. Note: Exception for legacy funds applies to the prohibitions in (1) and (2) above, if an amendment to the fund's governing documents would be needed to comply.	
Preferential Treatment Disclosure Requirement. The Proposed Rule would have prohibited private fund advisers from providing **other** preferential treatment, unless specific terms were disclosed to current and prospective investors.	All advisers to private funds (including RIAs and ERAs).	Yes, with modifications.	**Disclosures to prospective investors:** Advance written notice of any material economic terms that the adviser provides to investors in a fund must be given to prospective investors in the same fund. **Disclosures to current investors:** - *Illiquid Fund:* Written disclosure of all preferential treatment granted to all investors must be distributed to all	All advisers to private funds (including RIAs and ERAs).

Proposed Rule	Proposal Would Have Applied To	Adopted?	Adopted Rule	Adopted Rule Applies To
			investors in a fund as soon as reasonably practicable after the fundraising period. Adviser must provide annual updates showing specific information on preferential treatment granted since last disclosure. - *Liquid Fund:* Written disclosure of all preferential treatment granted to all investors must be distributed to an investor in a fund as soon as reasonably practicable after the investor's investment in the fund. Adviser must provide annual updates showing specific information on preferential treatment granted since last disclosure.	

REPORTING AND AUDITS

Proposed Rule	Proposal Would Have Applied To	Adopted?	Adopted Rule	Adopted Rule Applies To
Quarterly Statements within 45 Days of Quarter-End. The Proposed Rule would have required private fund advisers to provide fund investors with quarterly statements within 45	Registered investment advisers to	Yes, with modifications.	Quarterly statements for Q1, Q2, Q3 due within 45 days of quarter-end (75 days for funds of funds).	Registered investment advisers to

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days after each quarter-end.	private funds.		Quarterly statements for Q4 due within 90 days of the end of each fiscal year (120 days for funds of funds).	private funds.
Content of Quarterly Reports. The Proposed Rule would have required quarterly reports to include detailed information in the form of: (1) a fund table; (2) a portfolio investment table; and (3) performance information.	Registered investment advisers to private funds.	Yes, with minor modifications.	Advisers must provide quarterly reports to investors that include detailed information in the form of: (1) a fund table; (2) a portfolio investment table; and (3) performance information.	Registered investment advisers to private funds.
Audit Requirement. The Proposed Rule would have required advisers to obtain an audit from an independent auditor registered with the PCAOB and subject to inspection, and distribute audited financial statements annually and upon liquidation. The Proposed Rule would have required audits to be conducted in accordance with U.S.GAAP, and financial statements presented in accordance with U.S. GAAP.	Registered investment advisers to private funds.	Yes, with minor modifications.	Advisers will be required to obtain an audit that complies with the conditions for audits under the Advisers Act Custody Rule. Practically speaking, this is similar to the proposal.	Registered investment advisers to private funds.
Audits (Written Agreement). The Proposed Rule would have required advisers to enter into a written agreement with an independent public accountant conducting the required audit, pursuant to which the auditor would be required to notify the SEC of certain events.	Registered investment advisers to private funds.	No.	N/A.	N/A.

COMPLIANCE MATTERS

Proposed Rule	Proposal Would Have Applied To	Adopted?	Adopted Rule	Adopted Rule Applies To
Annual Compliance Review Documented in Writing. The Proposed Rules would have required registered investment advisers' annual compliance reviews to be documented in writing.	All registered investment advisers with respect to all clients.	Yes, with no modifications.	Registered advisers must, at least annually, review and document compliance reviews in writing	All registered investment advisers with respect to all clients.

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Please do not hesitate to contact us with any questions.

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