August 25, 2023

SEC Adopts Series of Rules Affecting Private Fund Advisers

On August 23, 2023, the Securities and Exchange Commission (the "SEC") voted 3 to 2 to adopt a series of sweeping new rules and rule amendments applicable to private fund advisers (the "Final Rules").[1] The SEC originally proposed new rules applicable to private fund advisers in February 2022 (the "Proposed Rules").[2]

In response to extensive public comment,[3] the Final Rules pare back some of the most controversial aspects of the Proposed Rules. For example, the Final Rules do not contain a prohibition on reimbursement, indemnification, exculpation, or limitation of liability for ordinary negligence. In addition, certain parts of the Final Rules now include "legacy status" for existing funds, under which an adviser will not be required to comply with certain of the Final Rules' requirements under existing contractual agreements governing a private fund that commenced operations prior to the compliance date of the Final Rules, and were entered into prior to the compliance date, if the restriction would require the parties to amend the agreements. However, the Final Rules will impose extensive requirements on private fund advisers and signal a departure from the SEC's longstanding principles-based approach to regulating private fund advisers under the Advisers Act.

This client memorandum provides an initial summary of the Final Rules and highlights key differences between the Proposed Rules and the Final Rules. We will publish a more detailed analysis of the Final Rules and key considerations for fund sponsors in the near future.

The Final Rules

***Restricted Activities*.** All private fund advisers (regardless of whether they are registered with the SEC) will be restricted from engaging in the following activities with respect to private fund clients, *unless* they satisfy certain disclosure and, in some cases, consent requirements:

- charging or allocating (1) any regulatory or compliance fees and expenses, or (2) fees and expenses associated with an examination of the adviser or its related persons, unless a written notice of such fees and expenses (including the dollar amount) is distributed to investors following the fiscal quarter in which the charge or allocation occurred;

- charging or allocating fees and expenses associated with an investigation of the adviser or its related persons, unless certain written consent requirements are met (with a blanket prohibition on charging or allocating fees and expenses related to an investigation that results in sanctions on the adviser for violating the Advisers Act);

- reducing the amount of an adviser clawback by actual, potential, or hypothetical taxes that are applicable to the adviser, its related persons, and their owners or interest holders, unless certain written disclosure requirements are met;

- charging or allocating fees or expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons (other than securitized asset funds) have invested (or propose to invest) in the same portfolio investment, unless (1) the non-pro rata charge or allocation is fair and equitable and (2) prior to charging or allocating such fees or expenses, the adviser distributes to each

investor a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances; and

- borrowing or receiving an extension of credit from a private fund client, unless certain disclosure and consent requirements are met.

***Preferential Treatment*.** All private fund advisers (regardless of whether they are registered with the SEC) will be restricted from engaging in the following activities:

- granting, directly or indirectly, (including by way of side letters) an investor in a private fund or in a similar pool of assets (excluding securitized asset funds) the ability to redeem its interest on terms that the adviser reasonably expects to have a "material, negative effect" on other investors in that private fund (or in a similar pool of assets), *unless* (1) the ability to redeem is required by applicable law, rule, regulation, or order of certain governmental authorities; or (2) the adviser offers the preferential redemption rights to all other existing and future investors in the private fund and any similar pool of assets without qualification (*e.g.*, no commitment size, affiliation requirements, or other limitations);

- providing, directly or indirectly, information regarding the portfolio holdings or exposures of the private fund or of a similar pool of assets (excluding securitized asset funds) 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 in a similar pool of assets, *unless* the adviser offers such information to all investors in the private fund or in a similar pool of assets at the same time (or substantially the same time);

- providing, directly or indirectly, any preferential treatment to any investor in a private fund, *unless* (1) specific information regarding any preferential treatment related to any material economic terms that the adviser or its related persons provide to other investors in the same private fund are disclosed to prospective investors in advance of such investors' investment in the private fund, (2) all preferential treatment the adviser or its related persons has provided to other investors in the same private fund are disclosed to investors as soon as reasonably practicable following the private fund's fundraising period (if the fund is an illiquid fund) or after the investors' investment (if the fund is a liquid fund), and (3) the adviser provides, at least on an annual basis, written disclosures of all preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided in accordance with the Final Rules.

Quarterly Statements. All SEC-registered advisers will be required to distribute quarterly statements to private fund investors incorporating granular information regarding private fund-level performance, compensation, fees and expenses, and portfolio investment-level compensation allocated or paid to the adviser and its related persons, reflecting such amounts both before and after the application of any offsets, rebates, or waivers.

***Annual Audits*.** All SEC-registered advisers will be required to obtain a financial statement audit that complies with Advisers Act Rule 206(4)-2 (the "Custody Rule") for each private fund.

Adviser-led Secondaries. All SEC-registered advisers will be required to obtain a fairness opinion or valuation opinion in order to conduct an adviser-led secondary transaction with respect to private funds that they advise and distribute a summary of material business relationships the adviser has (or has had) with the independent opinion provider.

Books and Records. All SEC-registered advisers will be required to comply with books-and-records requirements relating to the Final Rules.

***Written Annual Compliance Review*.** All SEC-registered advisers (regardless of whether they advise private funds) will be required to document in writing the annual review of their compliance policies and procedures required under Advisers Act Rule 206(4)-7.

***Compliance Periods*.** The compliance period for the rules regarding quarterly statements and annual audits is 18 months after publication in the Federal Register. The compliance period for the rules regarding adviser-led secondary transactions, preferential treatment, and restricted activities is either 12 or 18 months after publication in the Federal Register, depending on the adviser's private fund assets under management ("AUM"). The compliance period for the requirement to document annual compliance reviews is 60 days after publication in the Federal Register.

What Has Changed?

The following chart summarizes the key differences between the Proposed Rules and the Final Rules:

Proposed Rules	Final Rules
Scope / Compliance Date	
Scope: ▪ The proposed **Quarterly Statement**, **Audit**, and **Adviser-Led Secondaries Rules** would have applied to all SEC-registered advisers. ▪ The **Restricted Activities** and **Preferential Treatment Rules** would have applied to all advisers to private funds, regardless of whether they were registered with the SEC.	Scope: ▪ The **Quarterly Statement**, **Audit**, **and Adviser-Led Secondaries Rules** will apply to all SEC-registered advisers. ▪ The **Restricted Activities** and **Preferential Treatment Rules** will apply to all advisers to private funds, regardless of whether they are registered with the SEC. ▪ The **Quarterly Statement**, **Audit, Adviser-Led Secondaries**, **Restricted Activities**, and **Preferential Treatment Rules** will not apply to investment advisers with respect to securitized asset funds they advise. A securitized asset fund is any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders.

Compliance Date:
▪ **All proposed Rules and Amendments**: 12 months after the effective date (which is 60 days after publication in the Federal Register).
	Compliance Dates:
	▪ **Audit and Quarterly Statement Rules**: 18 months after publication in the Federal Register for all SEC-registered advisers.
	▪ **Adviser-Led Secondaries, Preferential Treatment, and Restricted Activities Rules**:
	  ▪ 12 months after publication in the Federal Register for private fund advisers with $1.5 billion or more in AUM.
	  ▪ 18 months after publication in the Federal Register for all other private fund advisers.
	▪ **Written Annual Compliance Review Rule**: 60 days after publication in the Federal Register for all SEC-registered advisers.

Prohibited Activities Rule	**Restricted Activities Rule – New Rule 211(h)(2)-1**
Any investment adviser to a private fund may not, directly or indirectly, do the following with respect to the private fund, or any investor in that private fund:	

Proposed Rules	Final Rules
▪ Charge a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment.	**Not adopted.** Note: The SEC suggests in the adopting release that it did not have to adopt the proposed restriction because the activity is already inconsistent with an adviser's fiduciary duty and advisers could be liable for engaging in such activity under the anti-fraud provisions of the Advisers Act.[4]
▪ Charge the private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority.	**Revised.** A private fund adviser ***may not*** charge or allocate fees and expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, ***unless*** the adviser requests each investor of the private fund to consent to, and obtains written consent from a majority in interest of the private fund's investors (excluding related persons of the adviser) for, such charge or allocation. However, a private fund adviser ***may not*** charge or allocate 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. Note: Legacy status ***will*** apply to the restriction on charging or allocating fees and expenses associated with an investigation, but not for such fees and expenses if the investigation results in sanctions.
▪ Charge the private fund for any regulatory or compliance fees or expenses of the adviser or its related persons.	**Revised.** A private fund adviser ***may not*** charge or allocate to a private fund any regulatory or compliance fees or expenses, or fees and expenses associated with an examination, of the adviser or its related persons; ***unless*** the adviser distributes a written notice of any such fees or expenses, including the dollar amount, to the investors of such private fund within 45 days after the end of the fiscal quarter in which the charge occurs.
▪ Reduce the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.	**Revised.** A private fund adviser ***may not*** reduce the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders, ***unless*** the adviser discloses the pre-tax and post-tax amount of the clawback to investors.
▪ Seek reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to	**Not adopted**. Note: The SEC states in the adopting release that this prohibition was "not necessary to achieve [its] goal to address [the] problematic practice" of advisers seeking to

Proposed Rules	Final Rules
the private fund.	avoid liability for breaches of fiduciary duty and other malfeasance.[5]
▪ Charge or allocate fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment.	**Revised.** A private fund adviser ***may not*** charge or allocate fees or expenses related to a portfolio investment on a non-pro rata basis, ***unless*** the adviser's allocation approach is fair and equitable and prior to charging the non-pro rata fee or expense, the adviser distributes to each investor written notice of the non-pro rata charge and a description of how the allocation approach is fair and equitable under the circumstances.
▪ Borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client.	**Revised.** A private fund adviser ***may not*** borrow money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client, ***unless*** the adviser (i) distributes to each investor a written description of the material terms of, and requests each investor to consent to, such borrowing, loan, or extension of credit; and (ii) obtains written consent from at least a majority in interest of private fund's investors that are not related persons of the adviser. Note: Legacy status ***will*** apply to the restriction on borrowing from private fund clients.
Preferential Treatment Rule	**Preferential Treatment Rule - New Rule 211(h)(2)-3**
Any investment adviser to a private fund may not, directly or indirectly, grant an investor in a private fund (or in a substantially similar pool of assets) the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or pool of assets ("preferential redemption rights").	**Revised.** Any investment adviser to a private fund may not, directly or indirectly, grant an investor a private fund (or in a *similar* pool of assets) preferential redemption rights, ***unless*** the ability to redeem is (1) required by applicable law, rule, regulation, or order of certain governmental authorities; or (2) the adviser offers the same redemption rights to all existing investors (and will continue to do so for future investors in the private fund or in a similar pool of assets). Note: Legacy status ***will*** apply to the restriction on granting preferential redemption rights.
Any investment adviser to a private fund may not, directly or indirectly, provide information regarding the portfolio holdings or exposures of the private fund (or of a substantially 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 pool of assets ("preferential information rights").	**Revised.** Any investment adviser to a private fund ***may not***, directly or indirectly, provide preferential information rights, ***unless*** the adviser provides such information to all investors in the private fund or in a similar pool of assets at the same time or substantially the same time. Note: Legacy status ***will*** apply to the restriction on granting preferential information rights.

Proposed Rules	Final Rules
Any investment adviser to a private fund may not provide any other preferential treatment to any investor in a private fund unless the adviser provides written disclosures to prospective and current investors of all preferential treatment provided to other investors in the same fund, as follows: ▪ Prospective investors: Advisers must provide notice prior to the investor's investment. ▪ Current Investors: Advisers must provide annual disclosure.	**Revised.** Any investment adviser to a private fund ***may not***, directly or indirectly, provide any preferential treatment (including preferential redemption rights and preferential information rights) to any investor in the private fund, ***unless*** the adviser provides written disclosures with respect to all preferential treatment provided to other investors in the same fund, as follows: ▪ Prospective investors: Advisers must provide advance notice of preferential treatment regarding material economic terms. ▪ Current Investors: Advisers must (1) distribute a written notice of all other preferential treatment (*i.e.*, all non-material economic terms) provided to other investors in the same private fund (i) for an illiquid fund, as soon as reasonably practicable following the end of the fund's fundraising period and (ii) for a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund, and (2) provide comprehensive annual disclosure of all preferential treatment (including redemption and information rights) provided to current investors.
Quarterly Statement Rule	**Quarterly Statement Rule - New Rule 211(h)(1)-2**
SEC-registered private fund advisers must provide standardized, quarterly statements to investors within 45 days after each calendar quarter end detailing: ▪ private fund-level cost information; ▪ portfolio investment-level compensation, fee, and other information; and ▪ standardized fund performance information (unless such quarterly statement is prepared and delivered by another person).	**Revised.** Distribution Timeline: SEC-registered private fund advisers must provide standardized, quarterly statements to investors: ▪ within 45 days after the first, second, and third fiscal quarter ends and 90 days after the end of the fiscal year of the private fund (for private funds that are not funds of funds); and ▪ within 75 days after the first, second, and third fiscal quarter ends and 120 days after the end of the fiscal year of the private fund (for private funds that are funds of funds). Statements must include: ▪ a detailed accounting of all compensation, fees, and expenses allocated or paid to the adviser or any of its related persons by the private fund during the reporting period (**Private Fund-Level**), and any offsets or rebates carried forward during the reporting period; ▪ a detailed accounting of all compensation allocated or paid to the adviser or any of its related persons by

Proposed Rules	Final Rules
	a covered portfolio investment during the reporting period (**Portfolio-Investment-Level**); and ▪ standardized fund performance information (unless such quarterly statement is prepared and delivered by another person). Offsets, Rebates, or Waivers: The Private Fund-Level and Portfolio-Investment Level disclosures are required to be presented both before and after the application of any offsets, rebates, or waivers. Calculations and Cross-references: The quarterly statements must include (1) prominent disclosures regarding the manner in which such amounts presented are calculated and (2) cross-references to the private fund's offering and organizational documents setting forth the applicable calculation methodology.
Adviser-Led Secondaries Rule	**Adviser-Led Secondaries Rule - New Rule 211(h)(2)-2**
SEC-registered private fund advisers may not conduct any adviser-led secondary transaction unless the adviser distributes to investors in the private fund, prior to the closing of the transaction, a fairness opinion from an independent opinion provider and a summary of any material business relationships with the provider.	**Revised.** SEC-registered private fund advisers must distribute either a fairness opinion or a valuation opinion from an independent opinion provider when offering existing fund investors the choice between (i) selling all or a portion of their interests in a private fund; and (ii) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. Private fund advisers must also provide the summary of any material business relationships with the provider within the two-year period preceding the relationship.
Audit Rule	**Audit Rule - New Rule 206(4)-10**
SEC-registered advisers must cause each private fund that they advise, directly or indirectly, to undergo a financial statement audit as follows at least annually and upon liquidation by an independent public accountant and prepared in accordance with U.S. GAAP.	**Revised.** SEC-registered investment advisers must cause each private fund they advise (other than a securitized asset fund) to undergo a financial statement audit; however, advisers may satisfy this requirement if the audit meets the requirements of the existing audit requirement in the Custody Rule.[6]
Private fund advisers must "promptly" distribute audited financial statements to current investors.	**Revised.** SEC-registered advisers must distribute audited financial statements in accordance with Custody Rule requirements, i.e., annual audited financial statements must be distributed to fund investors within 120 days of the end of a private fund's fiscal year and audited financial statements for liquidated funds must be

Proposed Rules	Final Rules
	distributed to fund investors promptly after the completion of such audit.
Private fund advisers must have a written agreement with the independent public accountant performing the audit of the private fund(s) to notify the Commission (i) promptly upon issuing an audit report to the private fund that contains a modified opinion and (ii) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.	**Not adopted.**
Compliance Review	**Annual Compliance Review - Amended Rule 206(4)-7**
SEC-registered advisers' annual compliance reviews must be documented in writing.	**Adopted.** SEC-registered advisers' (regardless of whether they advise private funds) annual compliance reviews must be documented in writing.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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1 *See* SEC Fact Sheet: Private Fund Adviser Reforms: Final Rules and Final Rules.

2 *See* SEC Fact Sheet: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews and Proposed Rules.

3 *See* Comments on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews.

4 *See* Final Rules at 253-255.

5 *See* Final Rules at 256.

6 In light of the adoption of the Private Fund Adviser Audit Rule, which generally requires an SEC-registered investment adviser to obtain an annual financial statement audit of each private fund it advises in accordance with the audit provision of the current custody rule, the SEC re-opened the comment period for its proposal entitled "Safeguarding Advisory Client Assets" in order to allow interested persons additional time to assess the proposed amendments to the current custody rule's audit provision in light of the Private Fund Adviser Audit Rule.