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Kirkland AIM

SEC Adopts Significant Rule Changes for Private Fund Advisers (Part 1 of 2)

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On August 23, 2023, the SEC voted 3-2 to adopt comprehensive new requirements under the Investment Advisers Act of 1940 (the “Advisers Act”) for investment advisers, primarily private fund advisers (the “Adopted Rules”).¹

The Adopted Rules represent the most significant in a series of rulemakings applicable to private fund advisers by the SEC, and follow on the heels of compliance with [the new Marketing Rule](#) and recently [adopted amendments to Form PF](#). While the Adopted Rules are expected to have a broad impact on private fund adviser practices and increase regulatory burdens, they have been tempered in many respects from the rules as proposed. Nevertheless, it is still possible that the Adopted Rules will be subject to future legal challenges.

As discussed below, in many instances where the proposals sought to provide a flat prohibition on certain adviser activities and expense practices, such activities and practices will remain permissible (now labeled “restricted” rather than “prohibited” activities) with appropriate disclosure and, in certain instances, investor consent. The SEC also removed two of the most contentious provisions: (1) the proposed prohibition that would have changed any negotiated standard of liability and related indemnification in a private fund’s governing documents to a simple negligence standard was not adopted, but the SEC took the opportunity to reiterate in the Adopting Release its previously stated views that an adviser’s federal Advisers Act fiduciary duties cannot be waived by agreement; and (2) the prohibition on reducing any carried interest clawback for taxes was not adopted and instead a disclosure requirement is imposed (as discussed below). In addition, the Adopted Rules also eliminated the proposals’ flat prohibition on charging funds or portfolio companies for “unperformed services” (e.g., accelerated monitoring fees) because, in the SEC’s view, such practices are already inconsistent with an investment adviser’s fiduciary duty. We are continuing to review the Adopting Release on these points.

In another change from the proposals, the rules provide “legacy status” (i.e., grandfathering) with respect to certain rules which will reduce the burden of amending existing agreements. However, consistent with the proposals, in many cases, the substantive requirements and restrictions of the Adopted Rules will apply to all investment advisers to private funds regardless of whether they are registered with the SEC.²

This *Kirkland AIM* provides an executive summary of key aspects of the Adopted Rules and will be followed by a separate *AIM* providing further detail.

The Adopted Rules³ will impose the following requirements on a fully SEC-registered private fund adviser:

- the adviser must provide investors with quarterly statements detailing fund-level information regarding fund performance, cost of investing in the fund, fees and expenses paid or incurred by the fund, as well as certain compensation and other amounts paid or allocated to the adviser. The quarterly statement must include prominent disclosure regarding the manner in which all expenses and offsets are calculated and include cross references to the fund’s organizational documents. Adopted largely as proposed, quarterly statements are required to be distributed within 45 days after the end of each of the first three fiscal quarters and 90 days after the end of each fiscal year (75 days and 120 days, respectively, for funds of funds);
- the adviser must obtain an annual audit of each private fund they advise (the audit will have the same substantive requirements as audited financial statements required under the current Custody Rule); and
- in connection with any adviser-led secondary transaction⁴ with respect to any private fund, the adviser must distribute to investors a fairness or other valuation opinion prepared by a third party in the business of providing such services, along with a written summary of certain material business relationships between the opinion provider and the adviser and its related persons within the two years immediately prior to the opinion issuance. An adviser must distribute these documents prior to the due date of the election form in which investors make a binding election to participate in the adviser-led secondary transaction.

The Adopted Rules will impose the following requirements on all private fund advisers, *whether or not registered with the SEC*:

- a private fund adviser will be restricted from engaging in certain activities and practices with respect to its private funds, including:

- charging or allocating fees and expenses associated with an SEC investigation of the adviser without written consent from a majority of a private fund’s investors that are not related persons of the adviser. The “legacy status” (i.e., grandfathering) protections extend to this restriction;
 - charging or allocating fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for an Advisers Act violation;
 - charging or allocating any regulatory, examination or compliance fees or expenses (“Compliance Costs”) of the adviser or its related persons unless the dollar amounts of such Compliance Costs are disclosed to fund investors within 45 days after the quarter end in which the charge(s) occur;
 - reducing the amount of an adviser’s carried interest clawback by the amount of certain taxes, unless the adviser discloses the pre-tax and post-tax amount of the clawback to investors within 45 days after the quarter end in which the clawback occurs;
 - charging fees or expenses related to an actual 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, unless (1) the allocation approach is fair and equitable under the circumstances and (2) the adviser distributes advance written notice to investors of the non-pro rata charge or allocation that includes a description of how the approach is fair and equitable under the circumstances; and
 - borrowing or receiving a loan from a private fund client, without disclosure to, and written consent from, a majority of a private fund’s investors that are not related persons of the adviser. The “legacy status” (i.e., grandfathering) protections extend to this restriction.
- a private fund adviser will be prohibited from providing preferential treatment (the “Preferential Treatment Rule”) with respect to redemption rights (subject to exceptions for redemptions required pursuant to applicable law – e.g., state pay-to-play, ERISA or banking laws – or for redemption terms that are offered to all investors) and information rights (subject to an exception for information rights offered to all investors) that the adviser reasonably expects to have a material, negative effect on other investors. The Preferential Treatment Rule also will require disclosure of other preferential treatment terms to current and prospective investors, with precommitment disclosure required for preferential treatment that relates to material economic terms and post-closing disclosure for other terms. The “legacy status” (i.e., grandfathering) protections extend to the Preferential Treatment Rule in respect of redemption rights and information rights only, and not to the disclosure portions of the Preferential Treatment Rule.

Finally, the Adopted Rules require all SEC-registered advisers (including those that do not advise private funds) to document the annual review of their compliance policies and procedures in writing.⁵

The Adopted Rules generally will not apply to securitized asset funds that otherwise meet the SEC's definition of private fund. The Adopted Rules have an effective date 60 days following the publication of the Adopted Rules in the Federal Register (the "Effective Date") with varying compliance dates described below:

- With respect to the Adopted Rule requiring annual compliance reviews to be documented in writing, the compliance date for all advisers will be 60 days from publication of the rule in the Federal Register (i.e., assuming that date falls in 2023, advisers will be required to document their next annual compliance review in writing).
- For the private fund audit rule and the quarterly statement rule, the compliance date is 18 months after the date of publication in the Federal Register (i.e., by Q2 2025 at the earliest).
- For the remainder of the Adopted Rules, the compliance date will be staggered based on the size of the adviser, with the earliest compliance date being 12 months from the date of publication of the rules in the Federal Register (i.e., Q4 2024 at the earliest) for advisers with more than \$1.5 billion in private fund assets under management. The compliance date will be 18 months from the date of publication of the rules in the Federal Register (i.e., by Q2 2025 at the earliest) for advisers with less than \$1.5 billion in private fund assets under management.

Please contact the Kirkland regulatory attorneys with whom you regularly work if you have questions regarding these Adopted Rules.

1. The Adopted Rules are available beginning on page 644 of the [Adopting Release](#).↩

2. Non-SEC-registered advisers subject to the Adopted Rules include exempt reporting advisers (e.g., mid-sized private fund advisers, venture capital advisers or certain non-U.S. advisers) and investment advisers not required to register with the SEC (e.g., foreign private advisers or certain advisers with AUM under \$100 million). Family offices relying on the Advisers Act exclusion from the definition of "investment adviser," however, are not subject to the Adopted Rules.↩

3. The SEC fact sheet summarizing the Adopted Rules is available through [this link](#).↩

4. In the SEC's view, an "adviser-led secondary transaction" includes any transaction that offers a fund's investors the choice between (1) selling all or a portion of their fund interests and (2) converting or exchanging all or a portion

of their fund interests into interests in another vehicle managed by the adviser or its related persons.↩

5. The Adopted Rules also include amendments to the books and records rule under the Advisers Act that would require advisers to retain records to facilitate the SEC's ability to assess an adviser's compliance with the Adopted Rules.↩

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Suggested Reading

- 05 May 2023 Kirkland AIM SEC Adopts Significant Amendments to Private Fund Adviser Reporting on Form PF
- 16 March 2023 Kirkland AIM SEC Proposes Enhancements to Regulation S-P and Takes Other Steps Related to Cybersecurity
- 17 February 2023 Kirkland AIM SEC Division of Examinations Issues 2023 Exam Priorities

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