SEC Finalizes Extensive Private Fund Reforms

On August 23, 2023, the SEC approved—in a three-to-two vote along party lines—a 660-page final rule that significantly expands oversight, disclosure, and audit requirements for private funds. Only minor changes were made from the February 2022 proposal.

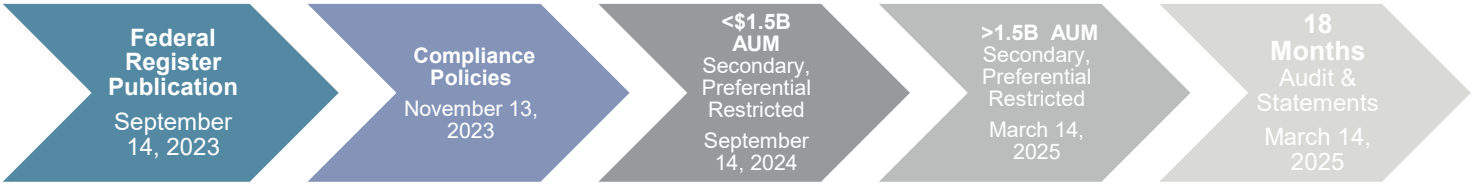
SEC-registered private fund advisers would be required to:

- Provide investors a quarterly statement with details on fund performance, fees, and expenses
- Obtain an annual audit for each private fund under the audit provisions of the custody rule
- Obtain a fairness opinion for adviser-led secondary transactions

All private fund advisers would be required to:

- Restrict certain activities without consent or disclosure
- Prohibit certain preferential treatment unless disclosed to current and prospective investors

All registered advisers, including those that do not advise private funds, would be required to document the annual review of their compliance policies and procedures in writing.



See Appendix for an overview chart.

Background

After the 2007 financial crisis, the Dodd-Frank Act increased the SEC's oversight of private funds, which broadly encompasses hedge funds, private equity (PE) funds, venture capital funds, and real estate private funds. Private fund investors are generally institutional investors, *e.g.*, retirement plans, trusts, endowments, sovereign wealth funds, and insurance companies, and high-net-worth individuals.

There are currently 5,037 registered private fund advisers with more than $26.6 trillion in private fund assets under management (AUM). The number of private funds has increased from 31,717 in 2012 to 100,947 in 2022. Advisers to private funds register with the SEC and have certain reporting and record-keeping requirements, most notably Form PF and Form ADV. The SEC continues to see instances of advisers acting on conflicts of interest that are not transparent to

investors, provide substantial financial benefits to the adviser, and potentially have significant negative impacts on the private fund's returns.

Scope

In response to comment letter feedback, the final rule excludes advisers of securitized asset funds (SAFs) from the requirements for quarterly statements, restricted activities, and preferential treatment. The SAF definition is consistent with Form PF and Form ADV: "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders."

I. Quarterly Statements

Registered private fund advisers would be required to distribute a quarterly statement to investors.

Certain private fund advisers are not subject to the quarterly statement rule—those solely advising less than $150 million private fund AUM and those with less than $100 million in regulatory AUM registered with the state and subject to state examination.

Timing

If the private fund is not a fund of funds, quarterly statements must 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. For a fund of funds, a quarterly statement must be distributed within 75 days after the first, second, and third fiscal quarter-ends and 120 days after the end of the fiscal year.

For a newly formed private fund, a quarterly statement must be prepared and distributed beginning after the fund's second full quarter of generating operating results.

Fees

The quarterly statement should include the following in a table format:

- **Adviser Compensation** – Details of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons[1] by the fund in the quarter. This includes—but is not limited to—management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation. Performance-based compensation is defined as allocations, payments, or distributions of capital based on a private fund's (or its investments') capital gains, capital appreciation, and/or profit. This broad definition captures—without limitation—

[1] "Related persons" are defined as:
(i) All officers, partners, or directors of the adviser
(ii) All persons directly or indirectly controlling or controlled by the adviser
(iii) All current employees (other clerical, administrative, or support staff) of the adviser
(iv) Any person under common control with the adviser

carried interest, incentive fees, incentive allocations, or profit allocations. This covers both cash and non-cash compensation, *i.e.*, in-kind allocations, payments, or distributions of performance-based compensation.

- **Fund Expenses** – Details of all other fees and expenses allocated to or paid by the fund in the quarter (whether advisory or non-advisory), with separate lines for each fee category. This includes—but is not limited to—organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses. Advisers must list each specific category of expense as a separate line item, rather than grouping fund expenses into broad categories. **There is no exclusion for de minimis expenses.**

- **Offsets, Rebates, & Waivers** – An adviser would present the amount of each compensation or expense category before and after any reduction for the reporting period, as well as any offsets or rebates carried forward during the quarter to subsequent quarters to reduce future adviser payments or allocations.

Portfolio Investment-Level Disclosure

A portfolio investment is any entity or issuer in which the private fund has invested directly or indirectly. This definition captures any entity or issuer in which the fund holds an investment, including through holding companies, subsidiaries, acquisition vehicles, and special purpose vehicles. For example, if a private fund invests directly in a holding company that owns two subsidiaries, this definition captures all three entities. The SEC elected not to use "'portfolio company"' for this disclosure since some funds do not invest in traditional operating companies. For example, some funds originate loans and invest in credit-related instruments, while others invest in assets such as music royalties, aircraft, and tanker vessels.

The SEC recognizes that fund of fund advisers may lack information or may not be given information for underlying entities, and depending on a private fund's underlying investment structure, a fund of funds adviser may have to rely on good faith belief to determine which entity or entities constitute a portfolio investment. An adviser should document this determination and its initial and ongoing diligence efforts to determine whether a portfolio investment has compensated the adviser or its related persons.

For any **covered**[2] portfolio investment, advisers must disclose details of all covered portfolio investment compensation allocated or paid by each covered portfolio investment during the quarter, in a single table. This includes—but is not limited to—origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees, or similar fees by the covered portfolio investment to the investment adviser or any of its related persons. The amounts reported should be both before and after any offset, rebate, or waiver.

This requirement does not include distributions representing profit or return of capital to the fund, *e.g.*, dividends.

In response to comment letter feedback, the final rule drops a proposed requirement to disclose a fund's ownership percentage of each covered portfolio investment.

[2] A covered portfolio investment is defined as portfolio investments that allocated or paid the investment adviser or related persons investment compensation during the reporting period.

Performance Disclosure

Advisers are required to provide quarterly fund performance information. Criteria used and assumptions made in calculating performance should be prominently displayed in the quarterly statement; the information cannot be included only in a separate document, website hyperlink or QR code, or other separate disclosure.

An adviser must first determine whether its fund client is an illiquid or liquid fund. A fund that does not meet the definition of an illiquid fund would be a liquid fund. An illiquid fund has the following characteristics:

- Is not required to redeem interests upon an investor's request
- Has limited opportunities, if any, for investors to withdraw before fund termination

PE and closed-end funds would be classified as illiquid funds, as defined in this rule, if opportunities to redeem are limited.

Liquid Funds

For liquid funds, the quarterly statement would include annual net total returns since inception or for each fiscal year over the 10 years prior to the quarterly statement (whichever is shorter). Advisers also must report each fund's average annual net total returns over one-, five-, and 10-year periods. Disclosure includes the liquid fund's cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.

Because the population of liquid funds is highly diverse, the SEC declined to prescribe a definition for net total returns.

Illiquid Funds

Advisers to illiquid funds must disclose the following performance measures in the quarterly statement, shown **since inception** of the illiquid fund and computed with and without the impact of any fund-level subscription facilities:

- Gross internal rate of return[3] and gross multiple of invested capital[4]
- Net internal rate of return and net multiple of invested capital
- Gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately. The SEC acknowledges that categorizing a partially realized investment as realized or unrealized will depend on the facts and circumstances and may not always be purely objective. The final rule does not have a bright-line standard. Advisers should be consistent in how they determine realized and unrealized investments and provide sufficient disclosure to investors about the methodology and criteria used.

[3] Internal rate of return is defined as the discount rate that causes the net present value of all cash flows throughout the life of the private fund to be equal to zero.

[4] Multiple of invested capital is defined as the sum of: the unrealized value of the illiquid fund; and the value of all distributions made by the illiquid fund; divided by the total capital contributed to the illiquid fund by its investors.

For performance measures without the impact of fund-level subscription facilities (unlevered returns), advisers should calculate performance measures as if the private fund called investor capital. For performance measures with the impact of fund-level subscription facilities (levered returns), advisers should calculate performance measures reflecting the actual capital activity from both investors and fund-level subscription facilities, including any activity prior to investor capital contributions as a result of the fund drawing down on fund-level subscription facilities.

Advisers also must provide investors with a statement of contributions and distributions for the illiquid fund that presents:

- All capital inflows the fund has received from investors and all capital outflows distributed to investors since the private fund's inception, with the value and date of each inflow and outflow
- The net asset value of the fund as of the end of the reporting period

The SEC recognizes that certain funds rely on information from portfolio investments and other third parties to generate performance data and may not have this information prior to the statement distribution deadline. If quarter-end numbers are not available, an adviser is required to include performance measures through the most recent practicable date, generally the end of the prior quarter. The statement should reference the date through which the performance information is current.

The statement can include other performance metrics as long as the presentation of the metrics complies with the final rule's other requirements. The quarterly statement is subject to the SEC's anti-fraud provisions.

II. Audit Rule

Registered private fund advisers—including those that currently opt to undergo a surprise examination under the custody rule—will be required to have their private fund clients undergo an annual financial statement audit by a PCOAB-registered public accountant. The final rule more closely aligns with the custody rule's audit requirements. The rule mandates that audited, GAAP-compliant financial statements be distributed to investors within 120 days of fiscal year-end.

The SEC acknowledges that some advisers may not have control over a private fund client to mandate an audit, *e.g.*, when a sub-adviser is unaffiliated with a fund. For a fund that the adviser does not control and that is neither controlled by nor under common control with the adviser, the adviser should take **all reasonable steps** to cause the fund to undergo an audit. For example, a sub-adviser that has no affiliation to the fund's general partner could document the sub-adviser's efforts by including (or seeking to include) the requirement in its sub-advisory agreement.

Because a surprise examination under the custody rule will not meet this rule's audit requirements, this rule effectively eliminates the surprise examination option under the custody rule and the SEC acknowledges this may increase costs to investors.

In September 2022, the SEC issued a proposal that would update the broker-dealer customer protection rule to notify the SEC promptly if an audit report contains a modified opinion or within four business days of the auditor's resignation or dismissal from the engagement. In light of this final rule, the SEC is re-opening the comment period. See our **FORsights**™ article, "Changes Coming to Treasury Clearing & the Customer Protection Rule," for further details.

III. Adviser-Led Secondaries

A registered private fund adviser will be required to obtain a fairness opinion or valuation opinion for any adviser-led secondary transactions from an independent opinion provider.[5] In these transactions, advisers offer existing fund investors the option to sell or exchange all or a portion of their fund interests for interests in another vehicle advised by the adviser. Examples include single asset transactions (a fund selling a single asset to a new vehicle managed by the adviser), strip sale transactions (a fund selling a portion of multiple assets to a new vehicle managed by the adviser), and full fund restructurings (a fund selling all of its assets to a new vehicle managed by the adviser). If a tender offer allows an investor to retain its interest in the same fund with respect to the asset subject to the transaction on the same terms, *i.e.*, the investor is not required to either sell or convert/exchange, then the transaction would not qualify as an adviser-led secondary transaction.

To complete an adviser-led secondary transaction, advisers must either obtain a written opinion stating that the price being offered to the fund for any assets being sold as part of an adviser-led secondary transaction is fair (a fairness opinion), or obtain a written opinion stating the value (as a single amount or a range) of any assets being sold (a valuation opinion).

An adviser would be required to prepare and distribute to investors a summary of any material business relationships the independent opinion provider has or has had within the past two years immediately prior to the issuance of the fairness opinion or valuation opinion with the adviser or any of its related persons. Both the opinion and the summary of material business relationships must be distributed to investors before the due date for the election form.

IV. Restricted Activities

The final rule restricts all private fund advisers from engaging in the following activities unless they satisfy certain disclosure or consent requirements:

- **Investigation Fees.** To charge the fund for costs associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, an adviser must receive advance written consent from at least a majority of a fund's investors that are not related persons of the adviser, to charge the fund for such investigation costs. Regardless of any disclosure or consent, an adviser may not charge or allocate fees and expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for violating the *Investment Advisers Act of 1940*.
- **Regulatory Expenses.** To charge a fund for any regulatory, examination, or compliance costs of the adviser or its related persons, an adviser must distribute written notices to investors within 45 days after the end of the quarter in which the activity occurred.
- **Adviser Taxes.** To 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, the adviser must distribute a written notice to the fund's investors that includes the aggregate dollar amounts of the adviser clawback both before and after any such reduction of the clawback for actual, potential, or hypothetical taxes within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.

[5] Defined as a person who provides fairness opinions or valuation opinions in the ordinary course of their business and is not a related person of the adviser.

- **Non-Pro Rate Fees.** Charging or allocating costs related to a portfolio investment on a non-pro rata basis when more than one private fund or other client advised by the adviser or its related persons have invested in the same portfolio company is permitted when two conditions are met. The allocation must be fair and reasonable and is subject to a before-the-fact disclosure including the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances.
- **Borrowing.** To borrow money, securities, or other private fund assets or receive a loan or extension of credit from a private fund client, an adviser must distribute to investors a written notice and description of the borrowing's material terms, seek their consent for the borrowing, and obtain written consent from at least a majority in interest of the fund's investors who are not related persons of the adviser.

This change applies to all advisers to private funds, regardless of whether they are SEC-registered or exempt reporting advisers or prohibited from registration.

V. Preferential Treatment Rule

The final rule prohibits all private fund advisers from:

- Providing preferential terms to certain investors on fund redemptions. The final rule adds two exemptions based on comment letter feedback:
  - For redemptions required by applicable law, rule, regulation, or order of certain governmental authorities
  - If the adviser has offered the same redemption ability to all existing investors and will continue to offer the same redemption ability to all future investors without qualification
- Providing preferential information about portfolio holdings or exposures that the adviser reasonably expects to have a material, negative effect on the fund's other investors or in a **similar pool of assets**, unless the adviser offers such information to all other existing fund investors and any similar pool of assets at the same time or substantially the same time

The term "similar pool of assets" is used to prevent structuring. For example, in a master-feeder structure, some advisers create custom feeder funds for favored investors. Without a broad definition of similar pool of assets, the rule would not preclude such advisers from providing preferential treatment to investors in these custom feeder funds to the detriment of investors in standard commingled feeder funds within the master-feeder structure. The term includes a variety of pools, regardless of whether they are private funds, *e.g.*, limited liability companies, partnerships, and other organizational structures, regardless of the number of investors; feeders to the same master fund; and parallel fund structures and alternative investment vehicles. It also would include pooled vehicles with different base currencies and pooled vehicles with embedded leverage to the extent such pooled vehicles have substantially similar investment policies, objectives, or strategies as those of the subject private fund. In addition, an adviser would be required to consider whether its proprietary vehicles meet the definition of similar pool of assets.

Disclosures

The new rule prohibits all private fund advisers from providing preferential treatment unless disclosed to current and prospective investors.

Advisers are required to provide to **current investors** comprehensive, annual disclosure of *any material economic terms* provided by the adviser or its related persons since the last annual notice. The final rule also requires the adviser to distribute to current investors a written notice of *all preferential treatment* the adviser or its related persons has provided to other investors in the same private fund for an illiquid fund, as soon as reasonably practicable following the end of the fund's fundraising period and for a liquid fund, as soon as reasonably practicable following the investor's fund.

An adviser must provide to **prospective** fund investors, prior to investment, a written notice with specific information about *any material economic terms* the adviser or its related persons provide to other investors in the same fund.

Whether terms are preferential will depend on the facts and circumstances.

VI. Compliance Rule Amendments

The compliance rule currently requires advisers to review—at least annually—the adequacy of their compliance policies and procedures and implementation effectiveness but does not expressly require written documentation. These amendments will now require all registered advisers, including those that do not advise private funds, to document their annual review in writing. The new rule does not enumerate specific elements to be included in the review's written documentation. The rule is intended to be flexible to allow advisers to continue to use the review procedures they have developed.

The annual review documentation should made be promptly available to the SEC and the SEC staff upon request.

Transition Legacy Status

In response to comment letter feedback, the final rule contains legacy status for the preferential treatment and restricted activities rules and will apply to agreements entered into before the compliance date if the final rule would require the parties to amend the agreement. The fund must have commenced bona fide activities, including investment, fundraising, or operational activity.

The legacy provisions only apply to contractual agreements that govern the fund, which include—but are not limited to—the private fund's operating or organizational agreements, *e.g.*, the limited partnership agreement, the limited liability company agreement, articles of association, or by-laws; the subscription agreements; and side letters, or that govern the fund's borrowing, loan, or extension of credit.

Information in side letters that existed before the compliance date will be disclosed to other investors that invest in the fund post-compliance date; however, the identity of specific investors can remain confidential.

Conclusion

The asset management team at **FORVIS** has more than 50 years of experience providing accounting, tax, and consulting services to various types of investment holdings, including conventional debt and equity investments, loans, businesses, alternative investments, and other unique assets. As of August 2022, Convergence Optimal Performance ranked FORVIS as a top 25 accounting and audit firm to registered investment advisors. FORVIS also was ranked in the top 20 by AUM. We have experience providing services to fund complexes with net assets ranging from a couple million to several billion dollars. Our experience allows us to provide tailored services to help meet your unique needs. For more information, visit forvis.com.

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Appendix – Private Fund Adviser Rules: Overview Chart

The below chart[1] provides a summary overview of some of the new restrictions and requirements that apply to private fund advisers. The new Private Fund Adviser rules were adopted on August 23, 2023.

		Who[2]		When will this rule apply?[3]
		Registered Private Fund Advisers	All Other Private Fund Advisers[4]	
PREFERENTIAL TREATMENT (E.G., "SIDE LETTERS")	Prohibits advisers from granting preferential redemption or information rights about portfolio holdings that would have a material, negative effect on other investors in the private fund or a similar pool of assets. Legacy status and limited exemptions are available. For all types of preferential treatment, advisers must: • provide advance written notice to prospective investors of preferential treatment related to any material economic terms; and • provide timely after-the-fact and annual written notices to current investors of all preferential treatment.	✓	✓	Advisers with $1.5 billion or more in private fund assets under management (Larger Advisers): 12 months Advisers with less than $1.5 billion in private fund assets under management (Smaller Advisers): 18 months
RESTRICTED ACTIVITIES	Restricts advisers from engaging in certain activities, including (among others) charging or allocating certain fees and expenses to private funds, unless the adviser meets certain disclosure and, in some cases, consent-based exceptions. Legacy status is available.[5]	✓	✓	Larger Advisers: 12 months Smaller Advisers: 18 months
QUARTERLY STATEMENTS	Requires SEC-registered advisers to provide investors with quarterly information about private fund adviser compensation, fund fees and expenses, and performance.	✓		18 months
ANNUAL AUDIT	Requires SEC-registered advisers to cause • each private fund they advise to undergo an annual audit as set forth in the custody rule (Advisers Act rule 206(4)-2), and • audited financial statements to be delivered to investors.	✓		18 months
ADVISER-LED SECONDARIES	Requires SEC-registered advisers that engage in adviser-led secondary transactions: • to obtain and distribute a fairness or valuation opinion; and • to provide a summary of any material business relationships between the adviser or its related persons and the independent opinion provider.	✓		Larger Advisers: 12 months Smaller Advisers: 18 months
RECORDKEEPING	Requires SEC-registered advisers to retain books and records related to each of the above requirements.	✓		See above for the timing for each of the related requirements
COMPLIANCE POLICY ANNUAL REVIEW	Requires SEC-registered advisers to document in writing the annual review they conduct pursuant to the compliance rule (Advisers Act rule 206(4)-7). This applies to all registered advisers, including those that do not advise private funds.	✓		60 days

Source: sec.gov

1. Prepared by staff of the Office of the Advocate for Small Business Capital Formation. It is not a rule, regulation, or statement of the SEC. The SEC has neither approved nor disapproved its content. This resource, like all staff statements, has no legal force or effect: It does not alter or amend applicable law, and it creates no new or additional obligations for any person. This resource does not provide legal advice.

2. Investment advisers to securitized asset funds will not be required to comply with the preferential treatment, restricted activities, quarterly statement, annual audit, adviser-led secondaries, and record-keeping requirements of the final rules solely with respect to the securitized asset funds that they advise.

3 Time periods begin after the rules are published in the **Federal Register**.

4 Including exempt reporting advisers and other advisers who are not registered with the Commission.

5 Further, an adviser may not charge fees or expenses related to an investigation that results in a sanction for a violation of the Advisers Act or the related rules.