SQUIRE PATTON BOGGS

SEC's New Rules Impact the Regulation of Private Fund Advisers

US – October 2023

The Securities and Exchange Commission (SEC) has adopted new rules that impact the regulation of private fund advisers. The regulator's intent is to improve transparency, competition and efficiency while protecting all investors, regardless of their size or level of sophistication.

Some of the proposals partially reflect current market practice (e.g., elements of the quarterly reports and fairness reports on general partner (GP)-led secondaries) while others (the preferential treatment rule) are less well-established practices. There are some GPs that accept such terms, but many still keep their arrangements with preferred-status limited partners (LPs) behind most-favored-nations (MFN) carve-outs.

The SEC backpedaled on some of the more contentious proposals, namely the proposed prohibition on limiting liability in fund documents for certain standards of misconduct (such as gross negligence) and charging fees for services not previously (and not expected to be) performed by a private fund adviser. The new rules are still contentious to the degree that several private equity and hedge fund trade groups have already sued the Securities and Exchange Commission (SEC), claiming the SEC did not have statutory authority to adopt the new rules.

Scope

1. The quarterly statement, private fund audit, and adviser-led secondaries rules (i.e., all those under "Transparency" below) apply only to SEC-registered private fund advisers.
2. The new rules regarding preferential treatment and restricted activities (See "Preferential Treatment" and "Restricted Activities" below) apply to all private fund advisers regardless of their registration status.
3. The SEC has clarified that the new provisions do not apply to offshore advisers to non-US private funds (regardless of SEC registration status) even if their funds have US investors.

Transparency

4. Private fund advisers must provide investors with quarterly statements detailing fund fees, expenses and performance.
5. Advisers must also obtain and distribute an annual financial statement audit for each private fund that they advise.
6. For GP-led secondary transactions, a fairness or valuation opinion is required.

Preferential Treatment

7. The new rules prohibit private fund advisers from offering preferential treatment to investors on redemptions rights, or portfolio-holding information or exposures, if such preferential treatment would reasonably be expected to have a material negative effect on other investors.
8. For all cases of preferential treatment, advisers are required to disclose to investors (i) in advance of any subscription by a prospective investor, any preferential material economic terms provided to other investors; (ii) written notice to investors of any other type of preferential treatment; and (iii) annual notice of any preferential treatment provided in the period since any prior written notice.

Restricted Activities

9. As described below, the new rules place limitations on advisers on several fronts, from the allocation of fees and expenses for regulatory investigations, to borrowing from a fund under management.
10. With respect to GP clawbacks, advisers may not reduce their clawback amounts by the hypothetical maximum tax payable (e.g., the maximum payable by a resident of New York City under city, state and federal taxes) unless they disclose the amount of clawback in both gross and net terms within 45 days of the end of the quarter in which the clawback occurs.
11. Advisers may not allocate costs among multiple funds under management on a non-pro rata basis, unless the allocation is fair and equitable in the circumstances (and the adviser asserts, in advance written notice to investors, why the allocation is fair and equitable).
12. Advisers are restricted from borrowing money, securities or other fund assets, or obtaining a loan or extension of credit, from a private fund client unless the adviser provides notice of the material terms of such arrangement to the fund's investors and obtains consent to such borrowing or extension of credit from a majority in interest of the fund's investors that are not affiliated with the advisor.
13. Advisers may engage in certain restricted activities if they disclose them appropriately and, in some cases, obtain investor consent.
14. However, advisers may not pass on certain investigation costs to the private fund once a violation of the Investment Advisers Act of 1940 is established.

Grandfathering

15. To avoid disruptions, the SEC will allow "legacy status" for existing governing agreements of funds that commence operations prior to the applicable compliance date for the relevant rule (even though the relevant agreements are not compliant).

Timing for Compliance

16. The rules will have an "Effective Date" 60 days after they are published in the Federal Register.
17. Private Fund Audit Rule and Quarterly Statement Rule – These rules will become effective 18 months after the Effective Date.
18. Adviser-led Secondaries Rule, Preferential Treatment Rule and Restricted Activities Rule – For advisers with $1.5 billion or more in private funds, these rules will become effective 12 months after the Effective Date; for advisors with less, these rules will become effective 18 months after the Effective Date.
19. Amended Advisers Act compliance rule – All registered advisers must comply 60 days after publication, documenting in writing the annual review of their compliance policies and procedures.

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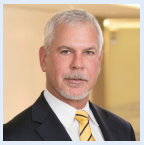

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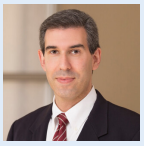

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Our Expertise with Private Funds

Our strong funds practice advises on the formation and ongoing operations of private funds of all asset classes, including venture capital, private equity, private debt and real estate. We have experience in supporting fund managers across the spectrum, from those doing deal-by-deal transactions, to those raising their debut fund to those who have raised private funds before.

Our lawyers have structured many investment funds and other pooled investment vehicles and managed accounts, including venture capital, real estate, private equity and private credit (including senior secured, mezzanine, special situations and others), and are well-versed in the legal and regulatory requirements associated with setting up and operating such structures. In addition, our broader experience with the legal and commercial structuring of investment funds on a global basis across many jurisdictions provides us with specialized insights into market-accepted terms and practices. We frequently act for investors into private investment and therefore have deep experience as to current market trends and investor expectations.

In addition, we provide ongoing counsel to investment funds throughout their entire lifespan, which includes advice regarding securities, tax, and other regulatory matters (including, in the US, with respect to the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and ERISA issues), operational matters (such as borrowings, transfers of fund interests, governance and liquidations), taxation, dispute resolution (including litigation and assistance with investor disputes), and legislative and regulatory developments affecting fund managers and the investment strategies they pursue.

We have extensive experience with various types of fund structures and managed accounts and employ a team approach to representing clients by drawing upon the skills of specialists in complementary areas including tax, securities, employee benefits, compensation, banking and financial services and anti-money-laundering laws, among others. Our cross-practice collaboration ensures we are providing the highest-quality representation possible and that our clients reap the benefits only a full-service, global firm can provide.