Blogs
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On August 23, 2023, the U.S. Securities and Exchange Commission (SEC) voted 3-2 along party lines to adopt new rules under the Investment Advisers Act of 1940 (the Advisers Act) for investment advisers to private funds. While they don't go as far as the SEC's original proposal, the rules impose significant new obligations and restrictions on private fund advisers. Some of these apply to all private fund advisers, including venture capital fund advisers (VC Fund Advisers) and other exempt reporting advisers (ERAs), while others apply only to SEC-registered private fund advisers (RIAs).

Crucially, the new rulemaking affords "legacy" status to certain existing arrangements that would otherwise be prohibited. Where noted below, a provision does not apply to "legacy" contractual agreements that (a) "govern

the fund," such as the fund's operating and organizational agreements, subscription agreements, and side letters, or (b) "govern the borrowing, loan, or extension of credit entered into by the fund," such as promissory notes, credit agreements, and provisions in the fund's governing agreements.

New Rules for All Private Fund Advisers

The new rules that apply to all private fund advisers, including VC Fund Advisers and other ERAs, address certain conflicts of interest "that have the potential to lead to investor harm," and prohibit activities that the SEC has characterized as "contrary to the public interest and the protection of investors."

The *compliance deadline* for these new rules is 12 months from publication in the Federal Register for advisers with $1.5 billion or more in private fund assets and 18 months for those with less than $1.5 billion.

- **Restricted Activities Rule.** All private fund advisers, including VC Fund Advisers and other ERAs, are restricted from engaging in the activities described below unless disclosure and/or consent requirements are met, or "legacy" treatment is available.
    - *Adviser Investigation Costs*. Advisers may not cause private fund clients to pay fees and expenses associated with an investigation of the adviser, *unless* the adviser obtains written consent. *Legacy status* is available to existing funds, except that the costs of an investigation that results in sanctions for Advisers Act violations may not be charged to a private fund under any circumstances.
    - *Adviser Compliance Costs*. Advisers may not cause a private fund client to pay for regulatory, examination, or compliance fees or expenses of the adviser, *unless* such fees and expenses are disclosed to investors within 45 days after the quarter end in which such charges occur.
    - *Clawback Reductions*. Advisers may not reduce the amount of their carried interest clawback by the amount of their taxes (actual, potential, or hypothetical), *unless* the pre-tax and post-tax amounts are disclosed to investors within 45 days after the quarter end in which such clawback occurs.
    - *Non-Pro Rata Allocation of Portfolio Costs*. Advisers may not charge or allocate fees or expenses related to an existing 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* (a) the non-pro rata allocation is fair and equitable and (b) the adviser provides advance written notice of the non-pro rata charge and a description of how it is fair and equitable.
    - *Borrowing from Private Funds*. Advisers may not borrow money or securities from a private fund client, *unless* the adviser provides sufficient disclosure and obtains written consent. *Legacy status* is available to existing funds.

- **Preferential Treatment Rule.** All private fund advisers are prohibited from providing investors with preferential treatment regarding redemptions and information if such treatment "would have a material, negative effect on other investors."
    - *Redemptions*. Advisers cannot provide preferential rights of redemption to private fund investors *unless* required by applicable law or the preferential treatment is offered to all investors "without qualification." *Legacy status* is available to existing funds.
    - *Portfolio Information*. Advisers cannot provide preferential information about private fund portfolio holdings or exposures, *unless* the information is offered to all current and potential investors. *Legacy status* is available to existing funds.

- *Transparency of Fund Terms*. Advisers cannot provide preferential terms to any private fund investor, *unless* material economic terms are disclosed prior to an investor's investment in the fund and other terms are disclosed after their investment. *This includes an annual report to investors on preferential terms.*

New Rules for RIAs

The new rules for SEC-registered private fund advisers are intended to "facilitate the provision of simple and clear disclosures to investors" about fundamentals of their investments and related conflicts of interest.

- **Quarterly Statement Rule.** RIAs are required to distribute quarterly statements to investors detailing fund performance, fees, and expenses, with prominent disclosures about how expenses, payments, allocations, rebates, waivers, and offsets are calculated and cross-references to the relevant sections of the fund's offering documents. The quarterly statements must generally be delivered to investors within 45 days after the end of each of the first three fiscal quarters and within 90 days after the end of each fiscal year. *Compliance deadline* is 18 months.
- **Private Fund Audit Rule.** RIAs are required to annually obtain and deliver private fund audits that are prepared by an independent public accountant and meet the custody rule requirements of the Advisers Act. The audit must be delivered within 120 days after the end of each fiscal year and promptly upon liquidation. *Compliance deadline* is 18 months.
- **Adviser-Led Secondaries Rule.** RIAs are required, when offering existing investors "the option between selling their interests in the private fund and converting or exchanging their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons," to obtain and distribute to investors (a) a fairness or valuation opinion and (b) a summary of any material business relationships between the adviser and the opinion provider that occurred within the previous two years. *Compliance deadline* is 12 months for larger advisers (? $1.5 billion in private fund assets) and 18 months for smaller advisers (< $1.5 billion in private fund assets).

Conclusion

The adoption of these rules is just one development within the long list of pending SEC rule proposals affecting the asset management industry. Indeed, along with the rulemaking summarized in this post, the SEC adopted rule amendments requiring written documentation of advisers' annual compliance program review, with a short 60-day compliance deadline.

We are carefully analyzing the new rules and expect to provide an in-depth update with suggested action steps for VC Fund Advisers and other private fund advisers in the coming weeks. Please don't hesitate to reach out to us as you work to digest the implications of the SEC's new rules.

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