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SEC Adopts Extensive New Rules for Investment Advisers to "Private Funds," but Excludes CLOs and Other "Securitized Asset Funds" from Those Rules

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In February 2022, the Securities and Exchange Commission (the "SEC" or the "Commission") proposed sweeping new regulatory requirements under the Investment Advisers Act of 1940, as amended (the "Advisers Act") for investment advisers that provide advisory services to "private funds." *See* https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf (the "Proposal"). At a meeting this past Wednesday, the Commission adopted those rules, with certain key changes, by a three to two vote. *See* https://www.sec.gov/files/rules/final/2023/ia-6383.pdf (the "Adopting Release"). Those new regulatory requirements, as adopted, narrow the regulatory differences between SEC-registered investment companies and private funds and significantly increase the Advisers Act regulatory burdens associated with managing a "private fund." The applicability of the new rules is not linked to the size of an investment adviser's assets under management.

The most administratively burdensome requirements – the quarterly statements and annual audit rules – apply only to SEC-registered investment advisers (other than to non-U.S. SEC-registered advisers in the context of their management of non-U.S. funds, whether or not those funds have U.S. investors). However, two of the new rules apply to any entity that is an "investment adviser" for purposes of the Advisers Act, whether or not SEC-registered, including to so-called Exempt Reporting Advisers (again subject to exclusions for certain non-U.S. non-SEC-registered advisers in the context of their management of non-U.S. funds).

The Adopting Release indicates that the proposals are motivated by a desire to make private funds more transparent to investors and to address practices that are perceived to involve conflicts of interest or deficient governance mechanisms. However, Commissioners Peirce and Uyeda (who cast the two "no" votes) raised questions regarding the need for extensive new regulations in a space that caters primarily to sophisticated investors, as well as regarding the statutory predicate for the new rules.

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WELCOME RELIEF FOR CLO MANAGERS

Although the Proposal was not focused on the managers of collateralized loan obligations ("CLOs"), it would (perhaps inadvertently) have included those managers within the scope of the proposed rules and substantially complicated the management of CLOs, without affording any clear regulatory benefits. In apparent response to the detailed CLO market concerns raised by the SFA, LSTA, SIFMA and other commenters on the Proposal, each of the newly adopted rules discussed below contains exclusions for investment adviser activities relating to "securitized asset funds." A "securitized asset fund" is defined in newly adopted Rule 211(h)(1)-1 as "any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders." This definition tracks the definition already used in Form PF and Form ADV; and, per the Adopting Release, is expressly intended to include CLOs. The Adopting Release indicates that the Commission excluded management of CLOs and other securitized asset funds from the new rules due to its recognition that these vehicles have structural features and risk profiles significantly different from the private funds at which the Proposal was targeted.

The Adopting Release makes clear that the new rules do apply to an investment adviser's management of credit funds and real estate funds, as well as to hedge funds, private equity funds, venture capital funds and other non-securitized asset funds.

SUMMARY OF NEW RULES

Quarterly Statement Rule

New Rule 211(h)(1)-2 under the Advisers Act requires an SEC-registered investment adviser to prepare quarterly investment statements for any private fund that it advises, directly or indirectly, and that has "operating results" for at least two fiscal quarters. If the fund is not a fund of funds, the statements must be distributed to investors within 45 days after the end of each of the fund's first three fiscal quarters and 90 days after the end of each fiscal year. In the case of a fund of funds, those distribution dates are increased to 75 days after the end of each of the first three fiscal quarters and 120 days after the end of each fiscal year. (Distribution is not required if statements complying with the rule are prepared and distributed by another adviser.) In the case of private funds in a control relationship (*e.g.*, a feeder fund under common control with a master fund), an adviser must look through the pooled vehicle investor to its underlying investors.

The statements must include certain specified information relating to the "reporting period" – presented both before and after the application of any offsets, rebates or waivers. Although the Proposal sought comment as to whether reporting should be made from the perspective of the ownership interests of individual investors, the rule, as adopted, requires reporting to be made only at the fund level. The rule requires advisers to consolidate reporting for "substantially similar pools

of assets" to the extent doing so would provide more meaningful information to investors and would not be misleading.

The information to be reported on the quarterly statements includes:

- A fund table containing a line-item accounting of all compensation, fees and other amounts allocated or paid to the investment adviser or any of its "related persons" by the fund, including "performance-based compensation," presented both before and after the application of any offsets, rebates or waivers. "Related persons" and the related term "control" are defined in the same manner as in the Glossary to the Form ADV. Although the Proposal sought comment as to whether the SEC should establish maximum fees that advisers may charge at the fund level or prohibit certain types of compensation arrangements, such as the "2 and 20 model" of performance fee, no such provisions were included.

- A fund table containing a line-item accounting of all fees and expenses allocated to or paid by the private fund, including organizational, accounting, legal, administration, audit, tax, due diligence and travel expenses, presented both before and after the application of any offsets, rebates or waivers.

- A fund table containing the amount of any offsets or rebates carried forward to subsequent reporting periods to reduce future payments or allocations to the adviser or its related persons.

- A separate table for the private fund's "covered portfolio investments," disclosing, as to each such investment: all "portfolio investment compensation" allocated or paid to the adviser or any of its related persons by the covered portfolio investment, with separate line items for each category reflecting the total dollar amount, presented both before and after the application of any offsets, rebates or waivers. The Commission did not adopt its proposal to require that the fund's "ownership percentage" of each investment and a description of the investment be included. A "portfolio investment" is defined as any entity or issuer in which the private fund has directly or indirectly invested; and a "covered portfolio investment" means a portfolio investment that allocated or paid the adviser or its related persons "portfolio investment compensation" during the reporting period. "Portfolio investment compensation," in turn, is broadly defined to mean any compensation, fees and other amounts allocated or paid to the adviser or any of its related persons attributable to the private fund's interest in such investment, including with respect to "origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing [and] disposition," as well as any director or trustee fees. The Adopting Release indicates that entry into a derivative or other negotiated instrument

with a counterparty generally would not be deemed to be an investment **in** the counterparty.

- "Prominent disclosure" regarding the manner in which all expenses, payments, allocations, rebates, waivers and offsets are calculated, along with cross-references to the applicable sections of the fund's organizational and offering documents.

- If the fund is a "liquid fund" each quarterly statement must present, with "equal prominence": (1) annual net total returns for each fiscal year for the shorter of the past 10 fiscal years or each fiscal year since inception; (2) average annual net total returns over the one-, five- and ten- fiscal year periods; and (3) the cumulative net total return for the current fiscal year, as of the end of the most recent fiscal quarter covered by the statement. "Liquid fund" is defined as any private fund that is not an "illiquid fund" (see bullet immediately below).

- If the fund is an "illiquid fund," the following are required to be shown, with "equal prominence," from the inception of the fund through the applicable quarter (or the most recent practicable date): (1) "gross IRR" and "gross MOIC" for the fund; (2) "net IRR" and "net MOIC" for the fund; and (3) "gross IRR" and "gross MOIC" for both the realized and unrealized portions of the fund's portfolio, shown separately. Those metrics must be computed **with and without** the impact of any "fund-level subscription facilities." A "statement of the contributions and distributions" for the fund must also be included. The term "illiquid fund" is defined as a private fund that: (1) is not required to redeem interests upon an investor's request; and (2) has limited opportunities (if any) for investors to withdraw before termination of the fund. This definition, as adopted, is significantly more streamlined than was the definition put forth in the Proposal. "Fund-level subscription facilities" is defined to mean "any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines, or other indebtedness … secured by the unfunded capital commitments of the private fund's investors." "Statement of contributions and distributions" is defined to mean "a document that presents (1) all capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund's inception, with the date and value of each inflow and outflow; and (2) the net asset value of the private fund as of the end of the reporting period." The Adopting Release indicates that the Commission would generally interpret the phrase "computed without the impact of fund-level subscription facilities" to require advisers to exclude fees and expenses associated with the facility, such as the interest expense, both when calculating performance and preparing the statement of contributions and distributions.

- "Prominent disclosure" of the criteria used and assumptions made in calculating performance.

Private Fund Mandatory Audit Rule

Although SEC-registered advisers that are subject to the Advisers Act "custody" rule – Rule 206(4)-2 (the "IA Custody Rule") – typically obtain annual audited financial statements for their pooled investment vehicles as a way to bypass the "surprise examination" requirement of that rule, the Adopting Release notes that not all SEC-registered investment advisers are subject to the IA Custody Rule and that the IA Custody Rule doesn't **mandate** that the adviser obtain annual audits. Newly adopted Rule 206(4)-10 accordingly requires an SEC-registered investment adviser that is not already obtaining an IA Custody Rule audit with respect to a private fund that it directly or indirectly advises to cause such private fund to undergo an annual financial statement audit that meets the requirements of paragraphs (b)(4)(i) through (iii) of the IA Custody Rule. Those audited financial statements must be distributed to fund investors in the same manner required by paragraph (c) of the IA Custody Rule. As originally proposed, Rule 204(6)-10 would have imposed requirements separate from those of the IA Custody Rule; however, as adopted, satisfaction of the IA Custody Rule satisfies Rule 206(4)-10.

Among other things, each required annual audit must: (1) be performed by an independent public accountant meeting the standards for independence specified in Regulation S-X that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board; (2) meet the definition of audit in Regulation S-X, which requires that financial statement audits be performed in accordance with U.S. GAAS; (3) be prepared in accordance with GAAP (except as otherwise interpreted by the SEC in the context of the IA Custody Rule); and (4) be delivered to investors within 120 days of the applicable fund's fiscal year-end, as well as promptly upon any liquidation.

In the case of a private fund with which an adviser does not have some type of "control" relationship, the adviser would be prohibited from providing advice to the fund if the adviser "fails to take all reasonable steps" to cause the private fund to undergo a financial statement audit that meets the requirements of paragraph (b)(4) of the IA Custody Rule. As noted, "control" is defined in a manner identical to the definition used in the Glossary to the Form ADV.

Adviser-Led Secondaries Rule

New Rule 211(h)(2)-2 makes it unlawful for an SEC-registered investment adviser to complete an "adviser-led secondary transaction" with respect to any private fund unless the adviser: (1) obtains and distributes to investors a "fairness opinion" or "valuation opinion" from an "independent opinion provider" relating to the applicable asset price; and (2) prepares and distributes to investors a written summary of any material business relationships the adviser or any of its related persons currently has

– or has had within the two years prior to the issuance of the fairness opinion or valuation opinion – with the independent opinion provider. Both such documents must be distributed to investors prior to the due date of the election form relating to the transaction. As originally proposed, Rule 211(h)(2)-2 could have been satisfied only by receipt of a fairness opinion, not a "valuation opinion."

"Adviser-led secondary" is defined to mean any transaction initiated by the adviser or any of its related persons that offers private fund investors the choice between: (1) selling all or a portion of their interests in the private fund; or (2) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or its related persons. Although the Proposal requested comment as to whether there are other transactions as to which a private fund adviser should be required to obtain a fairness opinion – *e.g.*, certain cross-transactions between private funds it manages – the proposed definition of this term was not broadened.

Restricted Activities Rule

New Rule 211(h)(2)-1 – which applies to any person that is an "investment adviser" for purposes of the Advisers Act, whether or not registered with the SEC under the Advisers Act (subject to exclusions for certain non-U.S. advisers) – restricts certain practices that the Adopting Release characterizes as having persisted "despite our enforcement actions and that disclosure alone will not adequately address." Those practices, which would be restricted whether they are engaged in directly by the adviser, or indirectly through a related person, are:

- Charging or allocating to the private fund fees or expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority UNLESS the adviser requests consent from each fund investor and obtains written consent from a majority in interest of investors that are not related persons of the adviser EXCEPT that an adviser may not charge or allocate such fees or expenses to the fund if the investigation results in a court or governmental authority imposing a sanction for a violation of the Advisers Act or the rules thereunder.

- Charging or allocating to the private fund any regulatory or compliance fees or expenses of the adviser or its related persons or any fees or expenses associated with an examination of the adviser or its related person UNLESS the adviser distributes a written notice to the fund investors regarding such fees or expenses, and the dollar amount thereof, within 45 days after the fiscal quarter in which the charge occurs.

- Reducing the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons or their respective owners UNLESS the adviser distributes a written notice to the fund investors that sets forth the aggregate

dollar amounts of the adviser clawback, before and after any such reduction, within 45 days after the fiscal quarter in which such clawback occurs.

- Charging or allocating fees and expenses related to a portfolio investment (or potential 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 may invest in that asset UNLESS: (1) the non-pro rata charge or allocation is "fair and equitable" under the circumstances; and (2) prior to effecting such charge or allocation, the adviser distributes a written notice to each investor and a description of how it is fair and equitable.

- Borrowing money, securities or other private fund assets from a private fund client or receiving an extension of credit from a private fund client UNLESS: (1) the adviser distributes to each fund investor a written description of the material terms of the proposed transaction; and (2) requests consent from each such investor and obtains written consent from at least a majority in interest of the fund's investors that are not related persons of the adviser.

In certain cases, "grandfathering" (or "legacy") treatment will be available with respect to the first and last bullet points above.

As originally proposed, the activities encompassed by each of the foregoing bullet points would have been subject to absolute prohibitions. However, as adopted, the rule permits those activities to occur, provided the applicable conditions are satisfied. The Proposal also would have precluded an adviser from seeking indemnification or limitation of liability for managerial actions that constitute "simple negligence" (as opposed to "gross negligence"), willful misfeasance, bad faith or recklessness. However, the Commission declined to include a straightforward prohibition, electing, instead, to "discuss [its] views on how an adviser's fiduciary duty applies to its private fund clients and how the antifraud provisions apply to the adviser's dealings with clients and fund investors."

Preferential Treatment Rule

New Rule 211(h)(2)-3 similarly applies to any person that is an investment adviser for purposes of the Advisers Act (subject to exclusions for certain non-U.S. advisers – whether or not registered with the SEC under the Advisers Act) – and would prohibit such an investment adviser from:

- Granting 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 UNLESS: (1) such ability to redeem is required by the applicable laws, rules, regulations or orders of any relevant foreign or U.S. governmental authority, including a state or political subdivision; or (2) the adviser has

offered the same redemption ability to all other existing investors and will continue to offer such redemption ability to all future investors. The Adopting Release indicates that whether an adviser could have a reasonable expectation that the preferential term would have a material negative effect on other investors depends upon the facts and circumstances. "Similar pool of assets" is broadly defined as a pooled investment vehicle (other than an SEC-registered investment company or company that elects to be registered as such) with "substantially similar investment policies, objectives or strategies," a determination that also would require a facts and circumstances analysis.

- Providing information regarding the portfolio holdings or exposures of a private fund – or a substantially similar pool of assets – to any investor if the adviser "reasonably expects" that doing so would have a "material, negative effect" on other investors UNLESS the adviser offers such information to all other existing investors at substantially the same time. As noted above, assessing "material, negative effect" would involve a facts and circumstances determination.

- Providing **any** preferential treatment to any investor in a private fund – including the preferential treatment described in the foregoing two bullet points – UNLESS the adviser: (1) provides each **prospective** investor with a written notice, prior to the investor's investment in the fund, providing specific information regarding any preferential treatment relating to "**material economic terms**" that the adviser or its related persons provide to other investors in the applicable fund; and (2) written notice to **current** investors regarding all preferential treatment provided to investors in that fund (*i.e.,* preferential treatment that doesn't relate to "material economic terms"). In the case of an "illiquid fund," such written notice to current investors must be provided as soon as reasonably practicable following the end of the fund's fundraising period. In the case of a "liquid fund," such written notice to current investors must be provided as soon as reasonably practicable following the investor's investment in the private fund. This bifurcated approach to disclosure was adopted in response to concerns that providing information regarding ALL preferential treatment before a prospective investor makes its investment might unnecessarily delay the ability to close a fund offering. In the case of both liquid and illiquid funds, current investors also must receive, at least annually, a written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the applicable fund since the previous written notice.

"Grandfathering" (or "legacy") treatment is potentially available with respect to both of the first two bullets.

Books and Records Rule Amendments

Rule 204-2 under the Advisers Act – the recordkeeping rule – was amended to make certain conforming changes. In particular, it requires retention of:

- The "preferential treatment" notices required by Rule 211(h)(2)-3, along with a record of each addressee and the dates sent.
- Each quarterly statement distributed pursuant to Rule 211(h)(1)-2, along with a record of each addressee and the dates sent.
- All records evidencing the calculation method for all expenses, payments, allocations, rebates, offset, waivers and performance listed on any quarterly statement.
- A copy of any audited financial statements distributed pursuant to Rule 206(4)-10, along with a record of each addressee and the dates sent; OR a record documenting steps taken by the adviser to cause a private fund that the adviser does not control, is not controlled by and is not under common control with to undergo a financial statement audit pursuant to that rule.
- Documentation substantiating the adviser's determination that a private fund client is a "liquid fund" or an "illiquid fund" for purposes of Rule 211(h)(1)-2.
- A copy of any fairness opinion or valuation opinion and material business relationship summary distributed pursuant to Rule 211(h)(2)-2, along with a record of each addressee and the dates sent.
- A copy of any notification, consent or other document distributed or received pursuant to Rule 211(h)(2)-1, along with a record of each addressee and the dates sent.

Compliance Rule Amendments

Rule 206(4)-7 under the Advisers Act was amended to require an SEC-registered investment adviser to document in writing the annual reviews that are undertaken pursuant to that rule, to assess the adequacy of the adviser's compliance policies and procedures. (Unlike the newly-adopted rules, this longstanding rule and the amendments thereto apply equally to CLO managers.) The Adopting Release notes that the written documentation is meant to be available to the SEC and its staff and should be produced promptly upon request. The Proposing Release sought comment as to whether the SEC should require the written documentation to address matters similar to those that Rule 38a-1 under the Investment Company Act of 1940 requires be addressed in the context of an SEC-

registered investment company, *e.g.*, each "material compliance matter" that occurred since the previous report. However, that approach was not followed.

Compliance Dates

The mandatory audit rule and the quarterly statement rule are subject to an 18-month transition period; *i.e.*, compliance is required 18 months following publication of the Adopting Release in the Federal Register. The rules relating to adviser-led secondaries, preferential treatment and restricted activities have staggered transition periods, based upon the amount of the adviser's assets under management. The amendments made to Rule 206(4)-7 become effective 60 days after the Adopting Release is published in the Federal Register.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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