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Navigating the SEC's New Private Fund Rules: Challenges Ahead for Sponsors and Advisers

The Securities and Exchange Commission (SEC) recently adopted new rules (Private Fund Rules) under the Investment Advisers Act of 1940, as amended (Advisers Act), which will have a significant impact on fund sponsors and the private funds they advise. The Private Fund Rules are intended to provide increased transparency and further protection to investors by, among other things, (i) requiring that private funds and their sponsors provide additional disclosures to all investors regarding preferential treatment of certain investors; (ii) restricting certain practices by private funds and their sponsors in the absence of additional disclosure to and consent from investors; and (iii) requiring SEC-registered advisers to provide investors with quarterly performance, fee and expense statements as well as annual audited financial statements of the private funds they advise. While it remains to be seen how the SEC will interpret the final rules, investment advisers should consider revising their policies and procedures now in advance of the SEC compliance dates.

Earlier this month, a consortium of six trade associations filed a lawsuit in the U.S. Court of Appeals for the Fifth Circuit challenging the validity and enforceability of the Private Fund Rules. The filing of the lawsuit does not stay any transition periods or delay any of the compliance dates set forth in the Private Fund Rules (although it is possible that a stay of the rules may be requested or granted by court order or as otherwise determined by the SEC). Historically, petitions challenging SEC rules (e.g., *Goldstein v. SEC* in 2006) have been filed in the D.C. Circuit. However, the trade associations' petition asserts personal jurisdiction in the Fifth Circuit, which has traditionally been more favorable than the D.C. Circuit to challenges of federal regulation. A copy of the petition can be found here.

The chart below summarizes key provisions of the new rules and includes select commentary. Generally, fund sponsors will need to be in compliance with the Private Fund Rules no later than March 14, 2025 (18 months after the date the rule was published in the *Federal Register*); however, "larger advisers" (i.e., advisers with assets under management attributable to private funds of $1.5 billion or more) are required to be in compliance with the Adviser-Led Secondaries, Restricted Activities and Preferential Treatment Rules no later than September 14, 2024 (12 months after publication in the *Federal Register*). The Written Annual Review Rule has a compliance date of November 13, 2023.

Certain provisions of the Restricted Activities Rule (borrowing and charging a fund for regulatory/governmental investigation fees and expenses) and the Preferential Treatment Rule (preferential redemption rights and portfolio holdings information rights) would not apply to existing private funds granted grandfathering status when the private fund has "commenced operations" and has made contractual arrangements prior to the applicable compliance date.

RULE PROVISION	SELECT COMMENTARY
Applicable to All SEC-Registered Investment Advisers	

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Written Annual Review: Annual review of compliance policies and procedures must be documented in writing.	We expect that most advisers are already documenting their annual reviews as a best practice.
Applicable to All Private Fund Advisers (including Exempt Reporting Advisers)	
Preferential Treatment – Disclosure Requirement: Before admitting an investor to a fund, advisers must provide *advance disclosure of material economic terms* granted preferentially to other investors and disclose *all* other preferential treatment "as soon as reasonably practicable" after the end of the fund's fundraising period (for illiquid funds) or the investor's investment (for liquid funds) and at least annually afterward.	The most-favored-nations process will unfold piecemeal, requiring fund managers to disclose terms to all investors. Funds in existence before the compliance date will need to disclose preferential terms to all investors in the fund, even though such terms have already been granted. We expect that this Preferential Treatment Rule will increase organizational costs for sponsors.
Preferential Treatment – Portfolio Holdings Information: Unless such information is offered to all investors, an adviser cannot provide preferential information about portfolio holdings or exposures if the adviser reasonably expects that providing the information would have a material, negative effect on other investors.	In the adopting release, the SEC noted that it is easier to trigger the material, negative-effect provision in funds with redemption rights and that generally it would not view preferential information rights granted to one or more investors in an illiquid private fund as having a material, negative effect on other investors.
Preferential Treatment – Redemption Rights: Unless such rights are required by law or offered to all other investors in the fund, an adviser cannot offer preferential redemption rights to investors if the adviser reasonably expects such terms could have a material, negative effect on other investors.	State pension systems and other institutional investors often negotiate special redemption rights, which will put pressure on sponsors to determine whether these have a material negative effect on other investors. The rule requires cross-references to sections of the fund's constituent documents setting forth the calculation methodology for expenses, payments, allocations, rebates, waivers and offsets; this will likely result in significant changes to how fund offering documents are drafted in the future.
Restricted Activities – Borrowing from Fund: Advisers cannot borrow money, securities or other fund assets or receive an extension of credit from a private fund without disclosure to and consent from investors.	The request for consent must be sent to all investors in the private fund, and the consent of at least a majority in interest (other than the adviser's related persons) is required.
Restricted Activities – Allocation of Investigation Fees/Expenses: Advisers cannot allocate or charge to the private fund any fees or expenses associated with an investigation of the adviser or its related persons by	If investigation fees are charged to the fund and the investigation results in a court or a governmental authority imposing a sanction on the adviser for violation of the Advisers

RULE PROVISION	SELECT COMMENTARY
any governmental or regulatory authority without disclosing and receiving consent from investors. **Advisers cannot allocate or charge the fund for fees and expenses for an investigation that results in a sanction for a violation of the Advisers Act.**	Act, the adviser must reimburse the fund for such fees and expenses associated with the investigation. The request for consent must be sent to all investors in the private fund, and the consent of at least a majority in interest (other than the adviser's related persons) is required.
Restricted Activities – After-Tax Clawback: Advisers cannot reduce the amount of a carried interest clawback by amounts due for certain taxes unless the pre-tax and post-tax amounts of the clawback are disclosed to investors within 45 days after the end of the fiscal quarter in which the clawback occurs.	
Restricted Activities – Regulatory/Compliance Costs: Advisers cannot charge or allocate to the private fund regulatory or compliance fees or expenses of the adviser or fees and expenses associated with a regulatory examination unless they are disclosed to investors within 45 days after the end of the fiscal quarter in which such charges are made.	The adviser is required to distribute a written notice of any such fees or expenses and the dollar amount incurred, with a detailed accounting of each fee as a separate line item rather than listing broad categories such as "compliance expenses."
Restricted Activities – Non-Pro Rata Investment-Level Allocations: Advisers cannot charge or allocate fees or expenses related to a portfolio investment on a non-*pro rata* basis when multiple funds and other clients are invested unless the allocation is "fair and equitable" *and the* adviser distributes advance notice of the charge and explains why the allocation is fair and equitable.	Determining whether an allocation is fair and equitable under the circumstances will depend on factors relevant for the specific expense. For example, it may be fair and equitable to allocate on a non-pro rata basis when the expense relates to a specific security that one private fund holds or an expense related to a bespoke structuring arrangement (e.g., an alternative investment vehicle) for one private fund to participate in a portfolio investment.
Applicable to SEC-Registered Private Fund Advisers Only	
Independent Fairness Opinion (Adviser-Led Secondaries Rule): Advisers must obtain and distribute to investors a fairness or valuation opinion from an independent opinion provider in connection with an adviser-led secondary transaction, and they must disclose recent material business relationships they have had with the independent opinion provider.	Costs for such transactions will increase, and those expenses will ultimately be borne by investors.

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Annual Audit: Advisers must obtain an annual audit for each private fund that meets the requirements of the audit provision in Rule 206(4)-2 of the Advisers Act.	
Quarterly Statements: Advisers must issue quarterly statements detailing information regarding performance, fund fees and expenses, and compensation received by the adviser or its related persons for each portfolio company.	The rule requires a detailed accounting of all portfolio compensation allocated or paid by each covered investment. This could pose a significant challenge for funds of funds, as such compensation may be difficult to determine at the underlying fund level. The reporting will need to specify amounts before and after the application of rebates, waivers or offsets. Performance metrics will vary greatly depending on whether the fund is an illiquid or liquid fund. Advisers must consider the impact of subscription facilities on returns and disclose such impact on a levered and unlevered basis for illiquid funds.
Non-U.S. Private Fund Advisers	
With respect to advisers whose principal office is outside the United States, none of the Private Fund Rules (other than the written annual review requirement for SEC-registered advisers) apply. This exemption applies whether the non-U.S. adviser is an exempt reporting adviser, foreign private adviser or SEC-registered adviser. The exemption would NOT apply with respect to any U.S.-domiciled funds that the adviser manages.	

Members of the Day Pitney Investment Management and Private Funds group are available to assist with any questions you may have regarding the Private Funds Rule and will continue to monitor the lawsuit as well as any other updates from the SEC on the Private Funds Rule. Please contact the Day Pitney lawyer you work with or any of the individuals listed in this Client Alert for further guidance.

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