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SEC's New Private Adviser Rules Offer Investors Increased Protections

On August 23, 2023, the Securities and Exchange Commission (SEC) adopted new rules under the Investment Advisers Act of 1940 (the Advisers Act) intended to "enhance" regulation of private fund advisers and to provide increased protections for private fund investors (the Final Rules). Adopted by a 3-2 vote split along party lines, the Final Rules represent the most significant regulatory action targeting private investment advisers since the Dodd-Frank Act was passed in 2010.

The Final Rules apply to U.S. advisers of private funds, including essentially all venture capital, private equity and hedge funds. The SEC confirmed that the substantive provisions of the Advisers Act, and thereby the Final Rules, do not apply to non-U.S. fund clients (including private funds) of SEC-registered offshore advisers, regardless of whether the funds have U.S. investors.

The Final Rules impose separate obligations and compliance deadlines on advisers depending on the rule, adviser size and the adviser's registration status.

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Rule Name	Applicable To	Compliance Deadlines
Restricted Activities	All private fund advisers	Large Advisors (AUM of $1.5 billion or more) – 12 months after publication in the federal register Smaller Advisers (AUM of less than $1.5 billion) – 18 months after publication in the federal register
Preferential Treatment	All private fund advisers	Same as above.
Adviser-Led Secondaries	SEC-registered private fund advisers	Same as above.

A brief summary of the Restricted Activities, Preferential Treatment, and

Adviser-Led Secondaries rules is included below. *We have omitted discussion of several other requirements, namely the Quarterly Statement, Private Fund Audit, Compliance Procedures and Practices, and Books and Records Rule amendments because many of these requirements mandate practices already implemented by private fund advisers in response to investor negotiations and market pressure.*

Restricted Activities

The Restricted Activities rule prohibits private fund advisers from engaging in the following practices, regardless of whether such practices are permitted by the funds governing documents unless certain disclosure and consent requirements have been satisfied.

1. Charging or allocating fees and expenses related to a portfolio investment on a non-pro rata basis unless (a) the allocation is fair and equitable under the circumstances; and (b) the adviser provides investors with written notice of the non-pro rata allocation and a description of how it is fair and equitable.

2. Reducing the amount of the adviser's clawback based on actual, potential or hypothetical taxes, unless the adviser provides notice to investors describing the aggregate dollar amounts of clawback before and after any reduction for taxes.

3. Charging or allocating fees or expenses for any regulatory, compliance or examination-related matters unless disclosed to investors.

4. Charging or allocating fees and expenses associated with an investigation of the adviser without consent of investors. Advisers are prohibited from charging or allocating fees and expenses related to an investigation resulting in penalties for the adviser.

5. Borrowing securities, money or other assets from the private fund without consent of investors.

Investors should be aware that the rules regarding borrowing and investigation fees and expenses do not apply to existing funds (meaning funds that have commenced operations as of the compliance date). Nonetheless, investors may wish to negotiate for these protections prior to the compliance deadline.

Preferential Treatment

The Preferential Treatment rule prohibits private fund advisers from providing preferential redemption rights and information on portfolio holdings that the adviser reasonably expects would have a material, negative effect on other investors in a private fund or similar pool of assets. These prohibitions are subject to several exceptions, including redemptions required by governmental action and where the adviser offers the same redemption ability to all existing investors.

The Preferential Treatment rule also requires advisers to disclose any preferential rights (other than redemption and portfolio holdings information) to current and prospective investors. This includes side letter or other terms relating to the cost of investing, liquidity rights, fee breaks and co-investment rights. Advisers' disclosure obligations vary depending on whether the investor is a current or prospective investor, and whether the fund is open-ended or closed.

Prospective Investors	Prior to investment in the private fund.
Current Investors – Open-Ended Funds	As soon as reasonable practicable following initial investment, and annually thereafter.
Current Investors – Closed-Ended Funds	As soon as reasonably practicable following the end of the fundraising period, and annually thereafter.

Similar to the Restricted Activities rule, the prohibitions related to preferential redemption rights and information on portfolio holdings do not apply to existing funds.

Adviser-Led Secondaries

The Adviser-Led Secondaries rule requires SEC-registered private fund advisers engaging in a "secondary transaction" to provide investors with (1) a fairness or valuation opinion from an opinion provider meeting certain independence and expertise requirements, and (2) a summary of any material business relationships the adviser or its affiliates has or has had with the independent provider within the previous two years. A secondary transaction is any transaction initiated by an adviser that offers investors the choice between redeeming their interests or converting them for interests in another vehicle managed by the adviser.

Takeaways and Next Steps

If the Final Rules remain in effect, investors will be able to leverage the new requirements to increase adviser transparency and to limit certain unfavorable practices. Furthermore, Investors with the requisite bargaining power may also be able to use the Final Rules as a road map for current negotiations, even in advance of the compliance deadline. Investors should be mindful, however, that industry trade groups have filed legal challenges against the SEC seeking to invalidate the Final Rules.

Given these ongoing lawsuits, the SEC may be reluctant to issue additional guidance interpreting the Final Rules. We will closely monitor these challenges and any future decisions to provide clients with the most up-to-date information regarding the enforceability of the Final Rules.

If you have any questions about the Final Rules and their impact on private fund investors, please contact a member of Reinhart's Institutional Investor Services Team.