

# To the Point

SEC – final rules

SEC requires private fund advisers to disclose more to investors and restricts certain activities

SEC Chair Gary Gensler said the final rules will benefit investors, issuers and the markets.

## What you need to know

- ▶ The SEC adopted rules requiring registered private fund advisers to provide investors with quarterly statements detailing fund performance, fees and expenses; obtain an annual audit for each advised private fund; and obtain a fairness or valuation opinion if they lead a secondary transaction.
- ▶ The rules restrict certain activities and prohibit all private fund advisers from providing certain treatment deemed preferential, as well as other types of preferential treatment, unless it is disclosed to current and prospective investors and/or the investors consent.
- ▶ While the rules apply to most private funds, they do not apply to advised securitized asset funds, and the audit requirement does not apply to a special purpose vehicle unless the adviser treats it as a separate client.
- ▶ Compliance with the quarterly statement and audit rules is required 18 months after publication in the Federal Register. Compliance with the other rules is required 12 or 18 months after publication in the Federal Register, depending on the amount of assets an adviser manages.

## Overview

The Securities and Exchange Commission (SEC) **adopted** new rules under the Investment Advisers Act of 1940 (Advisers Act) to enhance the regulation of private fund advisers and protect private fund investors by increasing transparency in reporting and restricting practices that the SEC deems contrary to investor interests.

Private fund advisers must distribute quarterly statements, obtain annual audits and obtain fairness or valuation opinions for adviser-led secondary transactions. They also are restricted from certain activities and prohibited from providing certain treatment to investors deemed preferential, unless disclosures are made and/or, in some cases, investor consent is obtained. Advisers are required to maintain books and records documenting their compliance with the rules.

The rules apply to hedge funds, private equity funds, venture capital funds, real estate funds and credit funds but do not apply to advised securitized asset funds (i.e., private funds whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders) such as collateralized loan obligations. The rules also generally do not apply to non-US clients (including private funds) of an offshore investment adviser. An adviser of a fund that is neither controlled by nor under common control with the adviser only has to take all reasonable steps to cause the fund to undergo an audit.

## Key considerations

### For registered private fund advisers

A registered private fund adviser must distribute for each advised fund a quarterly statement, which details fund performance, fees and expenses, to the private fund's investors within 45 days following the end of each of the first three fiscal quarters and 90 days from the fiscal year end. For a private fund of funds, the adviser must distribute a quarterly statement within 75 days of the end of each of the first three fiscal quarters and 120 days from the fiscal year end.

Quarterly statements must include a table with fund-level expense information (fund table) that discloses (both before and after the application of any offsets, rebates or waivers):

- ▶ All compensation, fees and other amounts allocated or paid by the private fund to the adviser or any of its related persons during the period, with separate line items for each category reflecting the total dollar amount (i.e., management, advisory, sub-advisory and performance-based compensation)
- ▶ All fees and expenses allocated to or paid by the private fund during the reporting period (other than adviser compensation), with separate line items for each category reflecting the total dollar amount (i.e., organizational, accounting, legal, administration, audit, tax, due diligence and travel expenses)
- ▶ The amount of any offsets or rebates carried forward to reduce future payments or allocations to the adviser or its related persons

Advisers cannot exclude *de minimis* expenses, generally group small expenses into broad categories or label expenses as miscellaneous in the fund table.

Quarterly statements must also include a separate portfolio investment table that discloses (both before and after the application of any offsets, rebates or waivers) for each covered portfolio investment (1) all portfolio investment compensation allocated or paid to the investment adviser or any of its related persons during the reporting period and (2) separate line items for each category of allocation or payment reflecting the total dollar amount, with categories that include origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments.

An adviser should generally disclose the identity of each covered portfolio investment to the extent necessary for an investor to understand the nature of potential or actual conflicts of interest with associated fees or payments. The portfolio investment table must list dollar amounts attributable only to the fund's interest in the portfolio investment.

The SEC said some fund of funds may have to rely on good faith belief to determine what entities constitute portfolio investments under the rule when there is a lack of information from underlying entities, and it recommended documenting such determinations. Quarterly statements must prominently disclose how all expenses, payments, allocations, rebates, waivers and offsets are calculated and include cross references to the applicable sections of the fund's organizational and offering documents.

Quarterly statements also must provide standardized fund performance information, including the date through which the information is current, and prominent disclosure of the criteria used and assumptions made in calculating the performance.

Advisers to liquid funds, which generally allow periodic investor redemptions, must show performance based on net total return on an annual basis for the shorter of the 10 fiscal years before the quarterly statement or since fund inception, over one, five and 10 fiscal-year periods and on a cumulative basis for the current fiscal year as of the most recent fiscal quarter end. Advisers to illiquid funds, which are not required to redeem interests upon an investor's request and have limited or no opportunities for investors to withdraw before the fund's termination, must show performance based on internal rates of return and multiples of invested capital since inception and present a statement of contributions and distributions.

Advisers also must provide consolidated quarterly statement reporting when doing so provides more meaningful and less misleading information for investors. For example, advisers of feeder funds must provide a single quarterly statement covering the feeder fund and the feeder fund's proportionate interest in the master fund on a consolidated basis, if doing so provides information that is more meaningful to investors and is not misleading.

In addition, private funds advised by a registered private fund adviser must undergo an annual financial statement audit that meets the requirements of the audit provision in the Advisers Act custody rule (Rule 206(4)-2(b)(4) and (c)). Registered private fund advisers must distribute to investors the audited financial statements within 120 days of the fund's fiscal year end and promptly upon liquidation. The SEC noted that a 180-day distribution period remains appropriate for a fund of funds and a 260-day period remains appropriate for a fund of funds of funds.

Audited financial statements must be prepared in accordance with US GAAP or a similar framework with material differences reconciled to US GAAP, and audits should generally be conducted in accordance with US GAAS. Annual audits must be performed by an independent registered public accountant who meets the independence standards under Rule 2-01(b) and (c) of Regulation S-X and is registered with and subject to regular inspection by the Public Company Accounting Oversight Board. This new rule effectively eliminates the surprise examination option under the custody rule for private fund advisers.

The SEC also clarified that if the adviser treats a special purpose vehicle (SPV) as a separate client, it must comply with the audited financial statement distribution requirements. If the adviser treats the SPV's assets as part of a pooled investment vehicle's assets that it is advising indirectly, the SPV's assets are considered in the scope of the pooled investment vehicle's financial statement audit.

A registered private fund adviser also must obtain a fairness or a valuation opinion when offering existing investors the option between selling their interests in a private fund and converting or exchanging their fund interests for those in another vehicle advised by the adviser or any of its related persons. The adviser must distribute to investors the opinion, as well as a summary of any material business relationships the adviser has or has had in the prior two years with the independent opinion provider, before the due date of the election form for the transaction.

Private funds should generally prepare annual financial statements in accordance with US GAAP and obtain annual audits conducted under US GAAS.

## For all private fund advisers

To prevent conflicts of interest, the rules restrict advisers from charging or allocating to the private fund (1) fees or expenses related to an investigation of the adviser or its related parties, unless disclosed to and consented by investors; (2) the adviser's regulatory, examination or compliance fees or expenses, unless disclosed; and (3) fees or expenses related to a portfolio investment on a non-pro rata basis, unless the allocation approach is fair and equitable and the adviser gives advance written notice of the charge and describes how the approach is fair and equitable under the circumstances.

The rules restrict advisers from reducing the amount of an adviser clawback by the amount of certain taxes, unless the clawback's pre-tax and post-tax amounts are disclosed. Advisers are also restricted from borrowing or receiving an extension of credit from a private fund client without disclosure to and consent from fund investors.

In addition, private fund advisers are prohibited from providing preferential terms to investors (e.g., they are prohibited from allowing certain redemptions from the fund unless the ability to redeem is required by law or the adviser offers the preferential redemption rights to all other investors). They are also prohibited from giving investors certain preferential information about portfolio holdings or exposures, unless it is offered to all investors.

All private fund advisers are further prohibited from providing preferential terms to investors, unless those related to material economic terms are disclosed by written notice to a prospective investor before investing in the fund and all preferential terms are disclosed after the investment and annually thereafter. The rules apply to preferential treatment provided through written side letters and other means, even if it is provided indirectly (e.g., by an adviser's related persons).

## Compliance dates and transition

The quarterly statement and audit rules are effective beginning 18 months from the date the final rules are published in the Federal Register. The adviser-led secondaries, restricted activities and preferential treatment rules are effective beginning 12 months after the Federal Register publication date for advisers with \$1.5 billion or more in private fund assets under management and 18 months for those with under \$1.5 billion in private fund assets.

Funds with certain preferential terms and restricted activity provisions in agreements existing prior to the compliance date do not need to amend their pre-existing agreements, though investor disclosure of such preferential treatment and restricted activities will still be required.

The rule requires all registered advisers, including those that don't advise private funds, to document the annual review of their compliance policies and procedures in writing beginning 60 days after publication in the Federal Register.

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