SEC Private Fund Advisers Rule Overview: Initial Analysis

August 30, 2023

Overview

The U.S. SEC passed the Private Fund Advisers rule on August 23, 2023. In the days since, we've begun our thorough analysis to better understand the full implications of the final rule, particularly for our member LPs and the millions they serve. The sweeping final rule:

- Reshapes key areas of interaction between LPs and GPs, representing advances in governance, transparency and alignment of interests
- Introduces a higher minimum standard for required transparency and engagement, including mandated LP consent in certain cases, across key areas such as quarterly fee and expense reporting, quarterly performance measurement, annual financial statement audits, continuation funds, treatment of certain fees and expenses and clawbacks
- Scales back certain elements relative to the original proposals, such as "prohibited activities" becoming "restricted activities" and a removal of language related to fiduciary duty, while others present some ambiguity in how negotiations will ultimately be impacted, particularly with respect to side letters

ILPA is committed to working with the SEC and directly with GP organizations and industry groups to ensure clarity around implementation guidelines, while at the same time guarding against lapses in industry practices where ILPA guidance exceeds the new minimum standards in the SEC's final rule.

As we push forward our analysis to cover deeper reviews of critical elements of the rule, we will also be monitoring the potential for litigation to be filed against the SEC by GP organizations. This is a fluid situation; as it progresses, we will be sure to provide insight into implications for implementation and the impact on LPs

Key Elements of the Final Rule

If you're new to the Private Fund Advisers Rule, please visit the ILPA website to understand the basics of what was proposed by the SEC, and the different areas where ILPA has been engaged on your behalf over the last 18 months.

Below, you'll find our initial takeaways on areas of the final rule of most pressing importance to LPs. In the weeks ahead, we'll offer additional insight on ILPA's response and recommended path forward.

Quarterly Statements

Adopted with only minor changes between the proposed and final rule. This rule (which also applies to those funds with existing contractual agreements in place) requires all registered private fund advisers to provide LPs with fund-level quarterly reporting across (i) fees and expenses (including separate line

items for organizational, accounting, legal, administration, audit, tax, due diligence and travel), as well as (ii) performance measurement (including with and without the impact of subscription lines).

Advisor Audit

Adopted with no real changes from what was proposed; the final rule (which also applies to those funds with existing contractual agreements in place) requires all registered private fund advisers to conduct and deliver annual financial statement audits.

Adviser-Led Secondaries

Adopted with the option of a valuation opinion or a fairness opinion, as originally proposed. This rule (which also applies to those funds with existing contractual agreements in place) requires all registered private fund advisers conducting an adviser-led secondary to provide LPs with either a fairness opinion or a valuation opinion from an independent provider prior to the due date of the election form.

Restricted Activities

Adopted with a meaningful shift from "prohibited activities" to instead "restricted activities," where activities originally proposed as prohibited would be allowed only where certain disclosure-based or consent exceptions are followed. This amended rule (which also applies to those funds with existing contractual agreements in place for the three disclosure-based restricted activities) requires all private fund advisers to provide written disclosures for certain activities – (i) Regulatory, Compliance and Examination Expenses, (ii) Clawbacks, and (iii) Non-Pro Rata Fee and Expenses. In addition to providing disclosure, private fund advisers must secure the consent of a majority interest of investors for certain activities – (i) Investigation Expenses and (ii) Borrowing – to carry out the activity.

Preferential Treatment – Other Preferential Treatment and Disclosure of Preferential Treatment

Adopted with significant changes to what was initially proposed, with the scope of required advance written notice narrowed to "material economic" terms that a GP grants to LPs in the same fund. This rule (which also applies to those funds with existing contractual agreements in place) requires all private fund advisers to provide (i) advance written notice related to any material economic terms provided to LPs in the same fund and (ii) written disclosure after the fund's fundraising period on all preferential treatment.

Preferential Treatment – Prohibited Preferential Redemptions and Prohibited Preferential Transparency

Adopted with significant changes, shifting to providing exceptions to prohibition based on certain conditions. This rule (which does *not* apply to those funds with existing contractual agreements in place) prohibits all private fund advisers from (i) granting preferential redemption rights that would have a material, negative effect on the other LPs in the fund or similar pool or assets (unless redemptions are required by law or the GP has offered the same redemption ability to existing/future LPs) and (ii) granting preferential rights related to portfolio holdings and/or exposure information that would have a material, negative effect on other LPs in the fund or similar pool of assets (unless the GP offers such information to all other existing LPs at the same time).

Prohibitions on Limiting or Eliminating Liability for Adviser Misconduct (i.e., Fiduciary Duty)

Though in the proposal, not adopted in the final rule in any form. Instead, the SEC is reaffirming its position as outlined in the 2019 IA Fiduciary Duty Interpretation with the view that GPs must adhere to federal fiduciary duty requirements under the Advisers Act and that reimbursement, indemnification or exculpation for breaching federal fiduciary duty would operate effectively as a waiver, and as such would not be permitted under the Advisers Act.

Legacy Status

The legacy status (formerly known as "grandfathering") will vary across the rules. A number of rules will apply to those funds with existing contractual agreements already in place (i.e., retroactively) after the compliance date, given the SEC's view that certain rules will not require existing agreements to be re-written (Quarterly Statements, Private Fund Adviser Audits, Adviser-Led Secondaries, Disclosure-Based Restricted Activities and Disclosure-Based Preferential Treatment).

Implementation

For the majority of rules, the implementation date will be 18 months after the date that the rule is filed with the Federal Register. A handful of rules will have a 12-month implementation window for any private fund advisers with greater than $1.5B in AUM (Advisor-Led Secondaries, All Restricted Activities, All Preferential Treatment).

This overview was developed in partnership with K&L Gates

CONTACT: industryaffairs@ilpa.org