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Three Important Dates For The Asset Management Industry: November 13, 2023, September 14, 2024, and March 14, 2025

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I. Introduction

The compliance dates for recently adopted rules extending to "private-fund advisers" ("PFAs")[1] are now known following their publication in the *Federal Register* [IA-Release No. 6383, 88 F.R. 63206 (Sept. 14, 2023)].

The rule package under the Investment Advisers Act of 1940 ("Advisers Act") includes the following requirements: (i) production and delivery of quarterly customer statements; (ii) the annual audit of the financial statements of private investment funds; (iii) production and delivery of fairness or valuation opinions in adviser-led secondary market transactions; (iv) prescriptive conflicts management in the context of five specific restricted activities; (v) prescriptive conflicts management in cases of preferential treatment of selected investors; (vi) review and documentation of an annual compliance review – a requirement that extends to all investment advisers, not only PFAs; and (vii) the maintenance of books and records related to the rules.

The rules become effective on **November 13, 2023** but the actual compliance dates for all other than documenting the annual compliance review (which also falls on **November 13, 2023**) are later. That is, compliance with the rules requiring the delivery of quarterly account statements and annual audits of private-fund financial statements is set for **March 14, 2025.** The compliance dates for the other rules directed at conflicts management, as discussed below, depend if the PFA is a large adviser ($1.5 billion or more in private fund assets under management) or a small adviser (less than $1.5 billion), in which case compliance is set at **September 14, 2024** and **March 14, 2025**, respectively.

Promptly after the SEC adopted the rules, the industry filed suit on September 1, 2023 in the Fifth Circuit, seeking a review of the SEC's order adopting the rules for purposes of vacating and setting them aside [*National Association of Private Fund Managers v. SEC* (Fifth Cir., No. 23-60471, filed Sept. 1, 2023)]. The petitioners, all industry associations, allege the SEC exceeded its statutory authority and adopted rules that are otherwise arbitrary and capricious and in violation of the notice-and-comment requirements of the Administrative Procedure Act and the SEC's heightened obligation to consider its rules' effects on "efficiency, competition, and capital formation."

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[1] Essentially, a PFA is an investment adviser that is registered, or is required to be registered, with the SEC and that sponsors and/or manages a pooled investment vehicle that would be an "investment company" subject to registration with the SEC but for exclusions from the Investment Company Act of 1940 ("1940 Act") contained in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. As noted herein, the rules conditionally permitting certain restricted activities extend to PFAs that are not required to register with the SEC, such as exempt reporting advisers. As noted herein, the rules are applicable to PFAs except PFAs to "securitization asset funds."

II. Summary of New and Amended Rules

Citing risk of investor harm due to the lack of transparency, the existence of conflicts of interest, and the absence of prophylactic governance mechanisms, the SEC adopted new rules and amended existing rules that will materially impact the private fund business. The rules are generally intended to apply to investment advisers to private investment funds (those funds excluded from the 1940 Act by Section 3(c)(1) and Section 3(c)(7)), other than private investment funds defined as "securitized asset funds" ("SAFs"), such as collateralized loan obligation and similar securitization structures, unless otherwise specified. In addition to new rules, the SEC amended the Advisers Act record-keeping rule, Rule 204-2, to require relevant records applicable to compliance with the new rules and amended the Advisers Act compliance rule, Rule 206(4)-7, to require all advisers to document their annual compliance reviews.

A. Quarterly Account Statements

By March 14, 2025, PFAs, other than advisers to SAFs, must comply with new Rule 211(h)(1)-2 under the Advisers Act with respect to their private fund management. These advisers must deliver quarterly account statements to fund investors within 45 days of each quarter end for the first three quarters of a fund's fiscal year and within 90 days of a fund's year end. The rule extends the delivery period for a fund of funds structure to 75 days and 120 days, respectively. Because the SEC does not permit a waiver of the quarterly account statement, a PFA is compelled to deliver a statement to each fund investor, even if the investor requests not receiving it.

According to the SEC, the "quarterly statement rule is designed to facilitate the provision of simple and clear disclosures to private fund investors regarding some of the most important and fundamental terms of their relationships with investment advisers—namely what fees and expenses those investors will pay and what performance they receive for their private fund investments."

1. Fees and Expense Disclosure

The account statement must contain clear and concise tabular disclosure of: (i) all fees paid by or allocated to the fund for payment to the PFA, the PFA's affiliates, or their control persons, such as insiders of the PFA or affiliate, (ii) line-item fund expenses allocated to or paid by the fund, and (iii) fee offsets or rebates (before and after the offset/rebate) and any rebates and offsets carried forward to another quarter. The disclosure must contain line items showing payments to the PFA, affiliates/control persons, and for matters, such as (but not limited to) management, advisory, sub-advisory, or similar fees or payments, performance-based compensation, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses.

2. Portfolio-Level Payments

The account statement also must contain clear and concise tabular disclosure of all compensation allocated to or paid by a fund for portfolio investment to the PFA, PFA's affiliates, or their control persons. According to the SEC, this disclosure would include "origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments by the covered portfolio investment to the investment adviser or any of its related persons."

3. Calculation Methodology

The quarterly statement must include prominent disclosure of the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated and the cross reference to the location in the organizational and offering documentation of the calculation methodology.

4. Fund Performance

The quarterly statement must include standardized fund performance. The required content will depend if the fund is deemed liquid or illiquid. For a liquid fund, the performance information must include: (i) annual net total return for each fiscal year over a ten-year period or since the inception of the fund, whichever is shorter; (ii) average annual net performance for one, five, and ten-year periods; and (iii) the cumulative net total return for the current fiscal year as of the most recent fiscal quarter covered by the quarterly statement. A liquid fund is any fund that is not an illiquid fund, as specified below.

For an illiquid fund, the performance information must include on a levered and unlevered basis gross internal rates of return ("IRR") (realized and unrealized), gross multiples of invested capital (realized and unrealized), and net IRR of the fund since inception. An illiquid fund for these purposes is a private fund that: (i) is not required to redeem interests upon an investor's request; and (ii) has limited opportunities, if any, for investors to withdraw before termination of the fund. For example, according to the SEC, a real estate equity fund would be illiquid for the performance reporting purposes.

B. Fund Audit Requirements

By March 14, 2025, PFAs, other than SAF advisers, must prepare annual audits of fund financial statements in compliance with the conditions prescribed by new Rule 206(4)-10 under the Advisers Act. According to the SEC, the mandatory audit requirement will serve several antifraud benefits, such as preventing any fraud, deception, or manipulation due to material misstatements in the financial statements available to fund investors. The SEC added that benefits of the audit process are intended "to address the conflicts of interest and potential compensation schemes that may result from an adviser valuing assets and charging fees related to those assets."

Rule 206(4)-10 requires each private fund (other than an SAF) to undergo an annual audit by an independent public accountant that is registered with, and subject to inspection by, the Public Company Accounting Oversight Board. The audit must meet the standards of Regulation S-X and be performed using generally accepted accounting principles. The PFA must deliver audited financial statements to fund investors within 120 days of the completion of the annual audit or promptly after a fund's liquidation. The audit requirements for these purposes are intended to track the SEC's custody rule, Rule 206(4)-2 under the Advisers Act (which itself is currently subject to proposed rule amendments). The mandatory audit requirements here, in effect, eliminate the custody rule's surprise audit alternative for private investment funds.

The rule implements a "look-through" process in the case of a master-feeder, fund-of-funds, or similar structure in which an affiliated/control person of the PFA is the investor in a private fund. Where no affiliation with the PFA exists, a look-through is not required for delivery purposes. Additionally, the SEC expressed limited flexibility in cases in which unforeseen circumstances delay the delivery of financial statements beyond the 120-day period. Although not expressed in the four corners of the rule, there may be support, albeit risky, for delivering audited financial statements after the 120-day deadline to the extent "reasonably unforseen."

C. Adviser-Led Secondary Transactions

By September 14, 2024, large PFAs ($1.5 billion or more in private fund assets under management) must deliver a fairness or valuation opinion, as well as a summary of material business relationships, as prescribed by new Rule 211(h)(2)-2 under the Advisers Act, if the PFA or an affiliate initiates a secondary transaction offering the investor the choice to sell all or portion its fund interests or convert/exchange all or a portion of its fund interests for interests in another fund advised by the PFA or affiliate. For smaller PFAs (below $1.5 billion in private fund assets under management), March 14, 2025 is the relevant compliance date. Rule 211(h)(2)-2 does not extend to SAF advisers.

According to the SEC, new Rule 211(h)(2)-2 addresses conflicts of interests raised by adviser-initiated secondary transactions because advisers may have economic incentives to favor their interests over a fund investor's, although the Advisers Act fiduciary duty, as well as other duties created by state law and/or the fund's organizational documents, would most certainly be expected to apply for purposes of managing relevant conflicts of interest.

1. Fairness or Valuation Opinion

Before completing a secondary transaction, Rule 211(h)(2)-2 requires a PFA to obtain a fairness opinion from an independent source that the pricing in a transaction is fair or, in lieu of a fairness opinion, a written valuation of assets impacted by, or part of, the secondary transaction. A PFA must deliver to fund investors the fairness or valuation opinion and a summary of material business relationship, discussed below, prior to the date an election form is due.

2. Summary of Material Business Relationship

The rule also requires disclosure of any material business relationship the PFA or its affiliates has to the independent provider of the fairness opinion or asset valuation for a two-year period prior to the issuance of the opinion or valuation. For purposes of the rule, an independent provider must be unaffiliated with the PFA and must in the ordinary course of its business issue fairness opinions and/or valuations. The rule does not define materiality, leaving that determination to a fact intensive analysis, although the SEC noted that a material business relationship would include "audit, consulting, capital raising, investment banking, and other similar services would typically meet [a materiality] standard."

D. Rules Restricting Fee/Expense Charges, Clawbacks, and Borrowings

By September 14, 2024, large PFAs must comply with a set of prescriptive conflicts management requirements in the case of specific activities noted below. For smaller PFAs, March 14, 2025 is the relevant compliance date. New Rule 211(h)(2)-1 under the Advisers Act codifies a system of disclosure and prohibitions as a means of conflicts management in cases of: (i) fee and expense charges and allocations for government-initiated investigations, certain compliance oversight, and certain portfolio investments, (ii) a reduction of an adviser clawback, and (iii) certain borrowings. Rule 211(h)(2)-1 does not extend to SAF advisers.

The applicable notice and consent obligations implement a look-through of any affiliated investment vehicle invested in the fund that is entitled to receive notice and give consent to the extent relevant. The prescriptions of new Rule 211(h)(2)-1 do not extend to certain legacy arrangements entered into prior to the compliance dates noted above other than any legacy arrangements permitting charges to cover the costs of an investigation that ultimately leads to sanctions for violations of the Advisers Act.

1. Regulatory Investigations

A PFA is prohibited from charging or allocating fees or expenses to a private fund for a regulatory investigation of the PFA or affiliate if a court or regulatory agency sanctions the PFA for violations of the Advisers Act as a result of the regulatory investigation. Otherwise, charging or allocating fees to the fund is permissible only if the PFA discloses the fees/expenses, seeks consent from all private fund investors, and receives the consent to the charges from at least a majority of fund investors.

2. Compliance and Regulatory Oversight

A PFA is permitted to charge or allocate fees/expenses to a private fund for compliance and/or regulatory examinations of the PFA or affiliate only if the PFA provides fund investors with written disclosure notifying them of the amount of the charges/expenses within 45 days of the quarter in which the fees/expenses were incurred. Consent is not required. The timing of this disclosure is intended to correspond with the quarterly account statement delivery discussed above, although large PFAs are obligated to comply with this requirement on September 14, 2024 before they are obligated to meet the March 14, 2025 compliance date for the delivery of quarterly account statements.

3. Clawbacks

A PFA is permitted to reduce the amount of performance-based fees owed to a fund (a "clawback") to cover tax liabilities on performance-based fees to the PFA, affiliates, or their respective owners (real, potential, or hypothetical) only if the PFA provides written disclosure to fund investors of the aggregate amount of the clawback before and after the reduction for taxes within 45 days of the quarter in which the reduction was implemented. Consent to the reduction in the amount of clawback is not required.

4. Fees/Expenses for Portfolio Investments on a Non-Pro-Rata Basis

A PFA is permitted to charge or allocate fees and expenses on a non-pro-rata basis in connection with a portfolio investment only if the method of allocating fees and expenses on a basis other than pro rata is fair and equitable and the PFA has notified fund investors of the fees and expenses and the support for the fairness of the fee/expense-allocation method. Consent is not required.

5. Credit Arrangements

A PFA may borrow money, securities, or other fund assets or receive a loan or an extension of credit from a private fund client only if the PFA provides written disclosure to all fund investors of the material terms of the arrangement, seeks consent of all investors, and obtains the consent of the majority of investors unaffiliated with the PFA.

E. Preferential Treatment

By September 14, 2024, large PFAs must comply with restrictions on the preferential treatment of certain private-fund investors. March 14, 2025 is the compliance date for small PFAs. New Rule 211(h)(2)-3 under the Advisers Act generally (i) prohibits, with limited exceptions, granting preferential redemption rights and preferential access to a fund's holdings or exposure that the PFA reasonably expects would "have a material, negative effect" on other investors in the fund and (ii), where any such preferences are permissibly compliant with the exceptions or any other preferences not otherwise specifically referenced, prescribes a written disclosure regime of the instances and effects of existing preferential treatment rights.

The rule can extend to a "similar pool of assets" to the fund, such as co-investment vehicles or a parallel fund containing a single investor, and arrangements directly between a preferred investor and the PFA or indirectly with an affiliated general partner. Rule 211(h)(2)-3 does not extend to SAF advisers or to legacy arrangements pre-dating the compliance dates identified above.

Going forward, the prescriptive rules regarding preferential treatment now regulate side letters and other negotiated agreements that previously operated under more general principles-based fiduciary standards. Not surprisingly, the insertion of prescriptive rules in established standard operating procedures proved controversial and doubtlessly partially provided impetus for the industry lawsuit.

1. Equal Terms

A PFA may permissibly grant preferential redemption rights and access to a fund's portfolio holdings or exposure if the PFA offered similar preferences to other fund investors. Any preferences granted in reliance on this exception must be disclosed to prospective and current investors.

2. Redemption Rights Required By Law

A PFA may permissibly grant preferential redemption rights if required by the applicable law of the jurisdiction to which an investor is subject. In this case, the PFA is not obligated to grant them to all fund investors but would be required to disclose them to prospective and current investors

3. Disclosure

In addition to the circumstances above, other instances of preferential treatment must be disclosed to prospective and existing fund investors. Thus, a PFA may permissibly enter into side arrangements granting certain preferential rights to fund investors or to investors in co-invest vehicles only if the PFA discloses the arrangements to prospective investors prior to their investment in the fund and to existing investors in an illiquid fund as soon as reasonably practical after the end of a fundraising period and for liquid funds as soon as reasonably practical after the existing investor's investment in the fund. Prospective investors are entitled to specific information about preferential treatment in respect of any "material economic terms," such as (according to the SEC) the cost of investing, liquidity rights, fee breaks, and co-investment rights, extended to other investors in the same fund. Existing investors in liquid and illiquid funds are entitled to information about all cases of preferential treatment extended to investors in the same fund, regardless of materiality.

The disclosure is subject to annual updating.

F. Documentation of Annual Compliance Review

By November 13, 2023, all SEC-registered investment advisers, including SAF advisers, must establish and implement policies and procedures to review and document annual compliance reviews of the effectiveness of the adviser's compliance program. As amended, Rule 206(4)-7 under the Advisers Act requires the adviser to "[r]eview and document in writing, no less frequently than annually, the adequacy of the policies and procedures established pursuant to [Rule 206(4)-7] and the effectiveness of their implementation." The amendment prescribes no specific format or delivery requirements, although the report would be subject to SEC examination, according to the SEC, regardless of any assertion of attorney-client privilege that may be asserted.

The SEC identified three key benefits to the amendment that, one, will assist advisers in considering compliance matters over the year, changes in business practices having an effect on compliance, and changes to applicable law impacting the adviser's compliance program. Second, the recording of the compliance review, in the SEC's view, will assist the SEC's examination staff in assessing the competency of the adviser's compliance program. Lastly, the SEC believes the documentation will assist due diligence reviews of the adviser.

III. Effect of Industry Lawsuit

A split vote of 3-2 accompanied the adoption the PFA rules, thus demonstrating their contested nature causing one SEC Commissioner opposing the rules to characterize them as a "retail-like." The controversy did not end with the SEC vote and has now moved to the courtroom, although the industry lawsuit challenging the permissibility of the SEC's rule package affecting PFAs did not seek a stay of the effective or compliance dates of the rules. It also did not challenge the permissibility of the rule amendments requiring the documentation of annual compliance reviews. Even if a stay were requested and granted pending the outcome of the litigation, PFAs nonetheless should begin preparing to comply with the rules on September 14, 2024 and March 14, 2025, as relevant to their private-fund business.

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