LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
THURSDAY, SEPTEMBER 28, 2023

PERSPECTIVE

DR. T ON SECURITIES

New SEC rules create industry chaos

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Regulation of investment advisers, including private fund advisers, has significantly increased over time. Rules proposed by the SEC back in February of 2022 have recently been adopted in late August 2023, albeit with some significant departures from what was previously proposed. After more than 300 public comments submitted over two rounds of comment periods, the SEC did not include some of the more controversial proposals originally envisioned, but the adopted Rules still have created an outcry from industry participants. A lawsuit was even filed on Sept. 1, 2023 by six prominent trade associations who are arguing the SEC "exceed[ed] the Commission's statutory authority." While the lawsuit will not halt the transition periods implemented by the Rules or delay compliance dates, it is possible there will be a stay of the rules if requested by court order.

In the interim while the industry watches and waits for the outcome of the lawsuit, private funds must forge ahead to find ways to comply with the new regulations and there are a lot of them. There are six new Rules and whether a fund is registered or relying on an exemption to registration, one or more of these six Rules will apply to them. Large private fund advisers with $1.5 billion or more in assets under management will have an 18-month window following the effective date of the Rules to be compliant with the Quarterly Statement Rule and Audit Rule, but only a 12-month window for the Adviser-Led Secondary Rule, Preferential Treatment Rule and Restricted Activities Rule. Smaller private fund advisers with less than $1.5 billion in assets under management will have an 18-month window for compliance with all Rules. The Written Annual Review Rule requires compliance within 60 days for all advisers.

Six sets of regulations & key takeaways

Restricted Activities Rule (211(h)(2)-1) - Applies to all advisers (including Exempt Reporting Advisers). The new Restricted Activities Rule generally prohibits advisers from engaging in certain activities unless specified conditions are met. The restricted activities are outlined below, along with the specified condition. Additional information and guidance is provided in the SEC's adopting release.

- Regulatory, compliance and examination expenses: Advisers may not charge or allocate expenses of any regulatory, compliance or examination fee or expense of the adviser unless they provide notice and dollar amount to investors in writing on at least a quarterly basis.
- Investigation fees and expenses: Advisers may not charge or allocate expenses associated with an investigation of an adviser or its related persons by any government or regulatory authority unless the adviser seeks consent from all of the investors. This consent option is not available if a court or governmental authority has imposed

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a sanction on an adviser.

- Post-tax clawback: Advisers may not reduce the amount of any performance, compensation clawback by actual or potential taxes unless they provide notice and dollar amount.
- Non-pro rata charge or allocation of fees and expenses: Advisers may not charge expenses related to a portfolio investment on a non-pro rata basis when more than one fund or other client advised by the adviser has invested in the same portfolio company unless the non-pro rata charge is fair and equitable and the adviser distributes a written notice prior to charging or allocating such expense.
- Borrowing and extensions of credit: Advisers may not borrow money, securities or other private fund assets or receive a loan or extension of credit from a private fund client unless the adviser distributes a written description of the proposed borrowing and obtains written consent from at least a majority of the fund's investors. This Rule would not impact borrowings made prior to the adoption of this Rule.

Preferential Treatment Rule (211 (h)(2)-3) - Applies to all advisers (including Exempt Reporting Advisers). Subject to limited exceptions, the new Preferential Treatment Rule prohibits all advisers from offering preferential redemption or portfolio transparency rights if providing such rights would reasonably be expected to have a material adverse effect on other investors.

- Preferential redemption: Advisers may not grant an investor the ability to redeem its interest on terms that the investment adviser reasonably expects to have a material, negative effect on other investors unless such redemption is required by applicable law, rules, regulations or orders of any relevant foreign or U.S. governmental or political subdivision to which the investor or the fund is subject.
- Preferential transparency: Advisers may not provide information regarding portfolio holdings or exposures to any investor if the adviser reasonably expects providing the information would have a material negative effect on other investors; however, the adviser is allowed to offer such information to all existing investors in the fund at the same time or substantially the same time.

Adviser-Led Secondary Rule (211 (h)(2)-2) - Applies to Registered Investment Advisers. For any adviser-led secondary transaction, the new Adviser-Led Secondary Rule requires investment advisers to provide a fairness opinion and a written summary of any material business relationships between the adviser or its related persons and the independent opinion provider in the two-year period prior to the issuance date of the opinion. Secondary sales by an investor that are facilitated by the investment adviser would not trigger the requirements under this Rule.

Quarterly Statement Rule (211 (h)(1)-2) - Applies to Registered Investment Advisers. The new Quarterly Statement Rule requires registered investment advisers to prepare quarterly statements disclosing fees, expenses and performance information. Such quarterly statements must be distributed to investors within 45 days after the end of each fiscal quarter for the first three quarters and 90 days after the end of the fiscal year. Distribution can be direct or through an electronic data room so long as the adviser informs investors when the quarterly statement is uploaded to the data room. It is important to note that investors cannot waive the Quarterly Statement Rule. Generally, investment advisers will be required to disclose detailed accounting of the following in their quarterly statements: (i) all compensation, fees and other amounts allocated or paid to the adviser or any of its related persons, (ii) all fees and expenses allocated to or paid by the fund during the reporting period and (iii) the amount of any offsets or rebates carried forward during the reporting period. Advisers must also provide a breakdown of all portfolio investment compensation allocated or paid to the adviser or its related persons. Finally, the Quarterly Statement Rule requires standardized performance information which varies depending on whether a fund is liquid or illiquid. The Quarterly Statement Rule outlines the performance information to be disclosed but includes such metrics as IRR (gross and net) and MOIC for illiquid funds and annual net total return for liquid funds.

Audit Rule (206(4)-10) - Applies to Registered Investment Advisers. Registered investment advisers are now required to obtain an annual financial statement audit of the private funds they advise and such audited financial statements must be delivered within 120 days of fiscal year end. Such audited financial statements must be audited by an independent public accountant that meets qualification requirements and must be in accordance with U.S. GAAP. For those funds who had not previously provided annual audited financial statements, it is important to obtain a few different quotes from potential auditors as the cost of conducting an audit can increase overall costs for investors. The SEC also reiterated that this Audit Rule would require audited financial statements for special purpose vehicles (SPV) if that SPV is treated as a separate client.

Written Annual Review Rule (206 (4)-7(b)) - Applies to Registered Investment Advisers.Current regulations require registered investment advisers to review the adequacy of their compliance policies and procedures on an annual basis. The new Written Annual Review Rule adds an additional requirement of documenting the annual review of compliance in writing.

Filling the compliance gaps

Regulation of private fund advisers is nothing new but the recently adopted rules from the SEC represent significantly increased attention to the regulation of private funds, so much so that the Rules have sparked lawsuits and outcry from the industry. Given the expansiveness of the Rules, private fund advisers should assess where their current compliance framework falls short of the Rules and work to plug any holes before the SEC is able to turn its attention to enforcement.

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