

The Future of Private Fund Advising: A Look at the 2023 SEC Regulations

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The Securities and Exchange Commission (SEC), Office of the Investor Advocate (the OIA), submits two reports to Congress each year. They are a:

- **Report on Objectives**, due each June 30, which sets forth the objectives of the OIA for the following fiscal year and
- **Report on Activities**, due each December 31, which describes the activities of the OIA during the immediately preceding fiscal year.

For its fiscal year 2023 Report on Objectives, one key area of focus is private fund adviser regulation. This article will address the proposals of the Report on Objectives.

With more than \$18 trillion in gross assets, private funds and their advisers play an important role in financial markets. In fiscal year 2023, the OIA will monitor the progress of new rules and amendments intended to enhance regulation of private fund advisers, as proposed by the SEC on [February 9, 2022](#), under the Investment Advisers Act of 1940 (the Advisers Act). This is a rulemaking of significant magnitude and, if adopted, will have far-reaching effects particularly on private funds' compliance programs.

As noted by the SEC's Chair Garry Gensler: "... *private fund advisers, through the funds they manage, touch so much of our economy. Thus, it's worth asking whether we can promote more efficiency, competition and transparency in this field.*" In approving the proposal, the SEC indicated that "... *the proposed reforms are designed to protect private fund investors by increasing their visibility into certain practices, establishing requirements to address practices that have the potential to lead to investor harm and prohibiting adviser activity that is contrary to the public interest and the protection of investors.*"

Specifically, if adopted as proposed, the new requirements and amendments would include the following rules.

Quarterly Statement Rule

The proposal would require registered private fund advisers to distribute a quarterly statement to private fund investors with a detailed accounting of all fees and expenses paid by the private fund during the reporting period. In addition, the statement would disclose information regarding compensation or other amounts paid by the private fund's portfolio investments to the adviser or any of its related persons.

The proposal also would require advisers to provide information regarding the private fund's performance. For example, for liquid funds, the quarterly statement would provide annual net total returns since inception, average annual net total returns over prescribed time periods and quarterly net total returns for the current calendar year. In turn, for illiquid funds, the statement would provide the gross and net internal rate of return and gross and net multiple of invested capital for the illiquid fund to capture performance from the fund's inception, through the end of the current calendar quarter.

Private Fund Audit Rule

The proposal would require registered private fund advisers to cause the private funds they advise to undergo a financial statement audit at least annually and upon liquidation. The proposal would require the audited financial statements to be distributed to investors promptly after the completion of the audit. These audits would provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees and protect private fund investors against misappropriation of fund assets. This is very significant as, historically, private funds were generally subject to audit requirements to satisfy the Custody Rule pursuant to the Advisers Act when their adviser was registered with the SEC.

Adviser-Led Secondaries Rule

The proposal would require a registered private fund adviser to obtain a fairness opinion in connection with an adviser-led secondary transaction. In these transactions, advisers often offer existing fund investors the option to sell or exchange their interests in the private fund for interests in another investment vehicle advised by the adviser. An independent, third-party expert would opine on the fairness of the price being offered to the private fund for any assets being sold as part of the transaction.

The proposal also would require the adviser to prepare and distribute to the private fund investors a summary of any material business relationships the independent expert has or has had within the past two years with the adviser or any of its related persons. This requirement would provide a check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors.

Prohibited Activities Rule

The proposal would prohibit all private fund advisers from engaging in certain activities and practices that tend to create conflicts of interest that could reasonably lead to fraud and investor harm because such practices incentivize an adviser to place its interests ahead of the private fund's interests. These practices include:

- Charging certain fees and expenses to a private fund or its portfolio companies, such as fees for unperformed services (e.g., accelerated monitoring fees) and fees associated with an examination or investigation of the adviser;
- Seeking reimbursement, indemnification, exculpation, or limitation of its liability for certain activities;
- Reducing the amount of an adviser "clawback" by the amount of certain taxes;
- Charging fees or expenses related to a portfolio company on a non-pro rata basis; and,
- Borrowing or receiving an extension of credit from a private fund client.

Preferential Treatment Rule

The proposal would prohibit all private fund advisers from providing preferential terms to certain investors regarding redemptions from the fund or information about portfolio holdings or exposures. It also would prohibit all private fund advisers from providing other preferential treatment, unless disclosed to current and prospective investors. This proposal is designed to protect investors by prohibiting specific types of preferential treatment that have a material, negative effect on other investors.

Books and Records Rule Amendments

The proposal includes amendments to the books and records rule under the Advisers Act that require advisers to retain records related to the proposed rules. The amendments would facilitate the SEC's ability to assess an adviser's compliance with the proposed rules.

Compliance Rule Amendments

The proposal includes amendments to the compliance rule under the Advisers Act that require all registered advisers, including those that do not advise private funds, to formally document their annual compliance review in writing.

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With all the changes included in the SEC's proposal, private fund advisers should take the time to carefully review their compliance program and assess the impact that such changes would have on their compliance function to determine if the help of compliance professionals is needed and where.

We at PKF O'Connor Davies can assist you with regulatory compliance or audit services so you can properly plan for current and proposed rulemaking and avoid any unintended consequences for your business, such as noncompliance and the associated costs as well as the difficulty of attracting subsequent capital infusions into your funds.

To help you navigate these proposed changes, please reach out to your PKF O'Connor Davies team members or:

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