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SEC Changes the Game for Private Fund Advisers – Summarizing the New "Restricted Activities Rule" and the "Preferential Treatment Rule"

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Hinshaw Alert

In early 2022, the Securities and Exchange Commission (SEC) proposed a series of new rules and rule amendments aimed primarily at increasing transparency and protecting investors in private fund transactions. This August, the SEC adopted final versions of those rules, which are set to become effective on November 13, 2023.

While the final rules are a somewhat diluted version of the originally proposed rules, they are still expected to significantly impact how private funds, and private fund advisers (*both registered and unregistered*), operate their businesses and deal with investors. Among the more material changes made part of those final rules is the introduction of the new "Restricted Activity Rule" and "Preferential Treatment Rule."

Background

The SEC proposed the initial rule changes on February 9, 2022. However, those proposed rules were almost immediately met with significant pushback from industry participants, and many commenters felt the proposed changes were too onerous or overreaching. Based on those received comments, on August 23, 2023 the SEC adopted (by a 3-2 vote) a heavily amended version of the rules (*the* "***Final Rules***").[1]

In its recent press release, SEC Chair Gary Gensler was quoted as saying:

"*By enhancing advisers' transparency and integrity, we will help promote greater competition and thereby efficiency. Consistent with our mission and Congressional mandate, we advance today's rules on behalf of all investors — big or small, institutional or retail, sophisticated or not*."[2]

This statement and the Final Rules are both very in line with what would be anticipated from the current SEC Chair. Since his appointment in 2017, a primary focus of Gensler has been heightened transparency and increased regulation to promote competition and efficiency in markets.

The Final Rules reflect significant changes from the initially proposed rules and, in many areas, are significantly laxer than originally presented. However, two very significant rules that made the cut are the "Restricted Activity Rule"[3] (*the*

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"***RAR***") and the "Preferential Treatment Rule"[4] (*the* "***PTR***"). It should be noted that, unlike the general effectiveness of the Final Rules, the RAR and the PTR will not become effective until late 2024/early 2025 (*as applicable*).[5]

What is the Restricted Activity Rule?

The RAR essentially prohibits private fund advisers from engaging in certain activities and practices which the SEC has deemed are contrary to the public interest and the protection of fund investors unless they provide certain required disclosures to fund investors and, in some instances, receive prior investor consent.

The prohibited activities primarily relate to areas of conflicts of interest between the fund adviser and the private fund that it advises, particularly matters related to the fees and other compensation to be received by such fund adviser (*or any of its related persons*).

Specifically, under the RAR, a private fund adviser is expressly prohibited from (*directly or indirectly*) doing any of the following:

- Charging, or allocating to, the private fund any regulatory, examination, or compliance fees or expenses of the adviser (*or any of its related persons*); **unless the adviser provides written disclosure to all investors in the subject private fund** that sets forth the aggregate dollar amounts of all such proposed fees and expenses within 45 days[6] after the end of the fiscal year in which the subject clawback occurs.
- Reducing the amount of any adviser clawback by any actual, potential, or hypothetical taxes applicable to the adviser (*or any of its related persons*); **unless the adviser provides written disclosure to all investors in the subject private fund** that sets forth the aggregate dollar amounts of the applicable adviser clawback both before and after all proposed reductions within 45 days[7] after the end of the fiscal year in which the subject clawback occurs.
- Charging, or allocating to, the private fund any fees or expenses related to a portfolio investment on a non-pro rata basis; **unless: (1) the allocation approach is fair and equitable, and (2) the adviser distributes advance written notice to all investors in the subject private fund** the sets forth both the proposed non-pro rata charge(s) and a description of how the proposed allocation approach is fair and equitable under the circumstances.
- Charging, or otherwise allocating to, the private fund any fees or expenses associated with an investigation of the adviser (*or any of its related persons*) by any governmental or regulatory authority; **unless: (1) the adviser provides written disclosure to all investors in the subject private fund** that sets forth both the aggregate dollar amounts and a reasonable description, of all such proposed fees and expenses; **and (2) the adviser receives written consent from at least a majority in interest of all investors in the subject private fund** (*that are unrelated to the adviser*).[8]
- Borrowing, or receiving an extension of credit, from any private fund client without disclosure to, and consent from, fund investors; **unless: (1) the adviser provides written disclosure to all investors in the subject private fund** that sets forth both the aggregate dollar amount of, and a reasonable description of all material terms with respect to, such proposed borrowing; **and (2) the adviser receives written consent from at least a majority in interest of all investors in the subject private fund** (*that are unrelated to the adviser*).

What is the Preferential Treatment Rule?

In the current private fund industry, fund advisers often grant select fund investors (*typically major investors*) certain preferential rights (*e.g., preferential redemption, information, or management participation rights*) which are not granted, or typically even disclosed, to other investors in the same private fund.

This practice has been traditionally handled through the use of confidential "side letter" agreements, or the like, between the fund and the subject investor receiving the preferential rights. The PTR however, marks a drastic departure from the foregoing practices.

Essentially, the PTR prohibits private fund advisers from providing any one or more fund investors with any of the following:

- Any right to redeem their interests (*in whole or in part*) in the subject private fund on terms that the adviser reasonably expects, if so redeemed, would have a material, negative effect on other investors in that private fund; **except where: (1) the adviser has offered the same redemption rights to all other existing investors in the same private fund and will offer the same redemption ability to all future investors in such fund; or (2) such redemption rights are required by applicable law.**
- Any information (*or right to receive any information*) regarding the subject private fund's portfolio holdings or exposures that the adviser reasonably expects, if so provided, would have a material, negative effect on other investors in that private fund.
- Any other preferential treatment **except where the adviser has fully satisfied its disclosure obligations to all current and prospective investors.**

Concerning the above-noted disclosure obligations, the PTR also requires private fund advisers to provide written disclosure to all current and prospective investors in the subject private fund, specifically identifying and describing any preferential rights related to redemption, information, or any other "*material economic terms*" that the adviser (*or its related persons*) provided to any particular investor(*s*) in the same private fund.[9]

Legacy Status

Commenters urged the SEC not to apply the proposed rules (*in particular the RAR and the PTR*) to existing private funds and related contractual agreements (*i.e., provide "legacy status" for such funds and agreements*). In response to received comments, as part of the Final Rules the SEC agreed to allow "legacy status" with respect to the bulk of the prohibitions under the RAR and the PTR.

Essentially, the prohibitions under the RAR and the PTR will not apply if, and to the extent, such activities are permitted under any governing agreements that were entered into prior to the effective date of such rules. However, there are several exceptions to the foregoing, many of which require a fact-based analysis of the respective circumstances. Among other things, the "legacy status" exemption:

- will apply only with respect to such existing governing agreements which would require the parties to amend such agreement to comply with the new rules;
- will not apply with respect to any disclosure obligations of advisers under the RAR or the PTR (*including the obligation to disclose all existing preferential rights to existing investors, even if the prior agreements were confidential*); and
- will not permit an adviser to charge, or otherwise allocate to, the private fund any fees or expenses related to an investigation that results, or has resulted, in a court or governmental authority imposing a sanction for a violation of the Investment Advisers Act of 1940 or the rules promulgated thereunder.

The Final Rules Are Already Facing Significant Opposition

From the beginning, the creation and adoption of the Final Rules has stirred strong, and diverging, opinions among private fund industry participants and even within the SEC itself. Commissioner Mark T. Uyeda was quoted in an SEC official statement as saying that:

> "*the Commission relies on questionable statutory authority, fails to consider the aggregate impact of the multitude of rules promulgated since 2022 affecting investment advisers, and dismisses warnings that it will have a disparate impact on smaller advisers, including those that are minority- and women-owned*."[10] Commissioner Hester Peirce also released an official statement arguing that the proposed new rules were "*ahistorical, unjustified, unlawful, impractical, confusing, and harmful*."[11]

If that weren't enough, the Final Rules, which haven't even yet actually become effective, are already being legally contested.

Despite pointing to the SEC's congressional mandate to create and adopt the Final Rules, litigation has already begun in the Fifth Circuit challenging portions of the Final Rules as unlawful.[12] Notably, the Fifth Circuit has already proven to be challenging for the SEC, having held the SEC administrative proceedings as "unconstitutional" last year. It remains unclear whether or not the Final Rules will survive this court challenge or if other similar actions challenging the Final Rules will emerge.

Conclusion

While far less restrictive than initially proposed, the Final Rules (*in particular, the RAR and the PTR*) will likely materially and significantly affect the private fund industry, and how every private fund adviser does business, going forward. Although many industry participants continue to oppose (*and some are even taking legal action to oppose*) the adoption of the Final Rules, without more, we have to assume that the Final Rules are here to stay.

Accordingly, while the effective date of the RAR and the PTR (*and certain other portions of the Final Rules*) are somewhat far off, private fund advisers should immediately start researching how these new rules will ultimately affect their fundraising and business operations.

We will continue to follow the implementation of the Final Rules and offer updates as further developments arise. In the interim, if you have questions or concerns regarding these rule changes, please contact **Anthony Zeoli, Timothy Sullivan, Andrew May, or Kyle Fonjemie**.

*Rebecca Clark, Law Clerk, was a contributing author.

[1] See "*Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*," Release No. IA-6368 (Aug. 23, 2023) available at: https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.

[2] See Press Release, "*SEC Enhances the Regulation of Private Fund Advisers*," (Aug. 23, 2023) available at: https://www.sec.gov/news/press-release/2023-155.

[3] Id. Section II(G), Pgs. 595-598.

[4] Id. Section II(G), Pgs. 257-297.

[5] The PTR becomes effective with respect to large private fund advisers (*those with $1.5 billion or more in private fund assets under management*) on [November 13, 2024] (*i.e. 12 mos. after the effective date of the Final Rules*), and with respect to all other private fund advisers [May 13, 2025] (*i.e. 18 mos. after the effective date of the Final Rules*),

[6] Note this 45-day requirement is intended to generally match the timeline required for fund advisers to distribute the required quarterly statements under the Final Rules.

[7] Id.

[8] It should be noted that under the RAR, even with notice and consent an adviser is prohibited from charging, or otherwise allocating to, the private fund any fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Investment Advisers Act of 1940 or the rules promulgated thereunder.

[9] Under the PTR the adviser is required to give such disclosures to: (a) prospective fund investors, in advance of their investment; and (b) existing investors, at least annually, and such disclosures may be limited to an identification of any preferential rights granted since the last disclosure given to the existing investors. It should also be noted that the timing of the foregoing disclosures with respect to existing investors will depend on the type of fund, with disclosures for "closed-end funds" being required as soon as reasonably practicable following the end of such fund's fundraising period and the

disclosures for “open-end funds” being required as soon as reasonably practicable following the investor’s investment in such fund.

[10] See “*Statement on Proposed Amendments for Substantial Implementation, Duplication, and Resubmission of Shareholder Proposals under Exchange Act Rule 14a-8*” (July 13, 2023) available at: https://www.sec.gov/news/statement/uyeda-statement-exchange-act-rule-14a-8-071322.

[11] See “*Uprooted: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Statement*” (Aug, 23, 2023) available at: https://www.sec.gov/news/statement/peirce-statement-doc-registered-investment-adviser-compliance-reviews-08232023.

[12] See *Jarkesy v SEC.* 34 F.4th 446 (5th Cir. 2022)