

New Rules for Private Fund Advisors from the SEC

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On August 23rd, the SEC adopted significant new rules for private fund advisors.

These rules address fund compliance, reporting, management, accounting, valuation, and engagement with LP's and investors (Final rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews ([sec.gov](#))).

Empire encourages you and your compliance team to carefully review the full SEC document. In the meantime, here is a summary of key issues and relevant items touching upon valuation.

Fund advisors registered (or required to be registered) with the SEC must,

- Provide private fund investors with quarterly financial statements, including detailed information regarding fund performance, fees and expenses, and obtain an audit annually [See Rules 211(h)(1)-2 and 206(4)-10].
 - The audits are intended by the SEC as an important check on fund advisers' valuations of private fund investments and against misappropriation of fund assets. The auditor must be registered with and subject to inspection by the PCAOB.
 - Official quarterly performance figures are to be prepared in accordance with GAAP, with a robust valuation process. The SEC specifically mentioned that use of "off-market assumptions" or "highly irregular valuation practices" would be viewed as deceptive.
 - Commentators have noted that lagged private valuation indicators and artificially smoothed performance could be an issue for certain PE and VC funds.
 - The SEC also cited an adviser charging investors a management fee and simultaneously charging a portfolio company a monitoring or similar fee without disclosing that fee to investors as fraudulent or deceptive because it involves an undisclosed conflict in breach of fiduciary duty.
- Annually review compliance policies for adequacy and implementation effectiveness, with such review documented in writing [Rule 206(4)-7].
- For adviser-led Secondary transactions that offer investors a choice to sell their interests or convert/exchange their interests for those in another adviser-led investment, get a fairness opinion or valuation opinion from an independent valuation provider.
 - This includes a written summary of any material business relationship between the fund adviser and opinion provider.
 - The objective here is to clearly minimize a fund adviser's conflict of interest in structuring secondary transactions. This looks to be an area of material SEC scrutiny.

- For Illiquid Funds (i.e., closed end funds not required to redeem interests upon request), show gross and net IRR and Multiple on Invested Capital (MOIC), realized and unrealized.
- For Liquid Funds (i.e., open end), show annual net total returns, average net total returns, and current cumulative net total returns.
- Preferential Liquidity and Disclosure Restrictions applicable to all private fund advisers:
 - Preferential liquidity for certain investors is prohibited if it would have a material negative effect on other investors.
 - Disclosure of investment holdings or exposures to only certain investors is prohibited if it would have a material negative effect on other investors.
 - A “legacy status” carve out is permitted for funds existing prior to the date of required compliance if compliance would necessitate amendment of governing agreements. [Ed. note: Side-letter disclosures may lead to uncomfortable conversations.]

As background to the adoption of the new rules, the SEC discussed several reasons why these new rules and investor protections were deemed necessary.



- Private fund assets under management (AUM) have grown from \$9.8 trillion in 2012 to \$26.6 trillion in 2022, while the number of private funds has tripled.
- Although fund investors were traditionally thought of as “sophisticated investors” who could monitor their own interests without the need for regulation, the SEC looked through this level to 26.7 million working and retired pension plan beneficiaries with indirect exposure to private funds.
- Private fund investments are opaque, and investors do not receive consistent detailed information describing the relationship of the advisers with the funds and investors.
- Calculating performance is complicated, and methods generally differ among advisers. Without comparable performance metrics and methodologies, it can be unclear how different advisers perform against one another. Performance calculations generally are the product of many assumptions and criteria, such as the manner in which management fee rates are applied. Without simple and clear disclosures of such assumptions and criteria, investors are at a disadvantage with respect to understanding or being able to verify how their investments are performing.
- Complicated private fund structures can contain conflicts of interest and may create difficulty in assessing overall compensation received by the adviser, fees and expenses being paid, and fund performance and returns.
- Similarly, advisers may have an inherent conflict of interest with the fund and investors when the adviser’s valuation of fund investments serve as a basis for the calculation of fees and fund performance.
- The SEC acknowledged that some funds may have limited partner advisory committees (LPACs) or Boards of Directors, but was concerned that the LPACs or Boards did not have sufficient independence or authority to oversee conflicts with the adviser acting on behalf of the fund client (as opposed to the investors).

The new rules were just issued and are still being digested and analyzed by funds and their attorneys, auditors, and valuation agents. The rules take effect between 60 days and 18 months after publication in the Federal Register.

We encourage you to review these rules in tandem with your fund policies and compliance procedures and contact us if you have questions. We are here to help.

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