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SEC Proposes Rule Changes for Private Fund Advisers

On February 9, the Securities and Exchange Commission (SEC) proposed new rules under the Investment Advisers Act of 1940 (the “Advisers Act”) to expand regulatory compliance obligations for investment advisers who advise private investment funds. The proposed rules, consolidated under new Rule IA-5955, titled “Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews” (the “Proposed Rules”), comes as a response to the SEC’s recognition of a need for reform in the regulation of private funds. The SEC noted that while private funds play a large and increasing role in the economy, the historical lack of transparency, visibility, and informational disclosures with respect to portfolio investments, adviser compensation, fund-related fees, costs, and expenses, and the methodology for calculating fund performance has resulted in an imbalance between the interests of private fund advisers, on the one hand, and the interests of private fund investors, as well as the general public, on the other hand. While the SEC has attempted to address such concerns by imposing and enforcing examination requirements on private funds, and advisers thereto, via prior rulemaking endeavors, such attempts have had little effect. Notwithstanding the aforementioned shortcomings of prior rulemaking, the Proposed Rules reflect the SEC’s continued interest in increasing transparency, competition, and efficiency in the private funds industry, with the ultimate goal of protecting, and rebalancing, the interests of private fund investors and the general public. While the Proposed Rules are ultimately subject to change, with the second comment period having only closed on June 13, 2022, and an established timeline for the release and adoption of a final rule forthcoming, if enacted as proposed, the Proposed Rules would impose the following material compliance obligations on private fund advisers:

Quarterly Statements

The Proposed Rules include a “Quarterly Statement Rule” requiring an investment adviser that is registered, or required to be

registered, with the SEC to prepare a quarterly statement for any private fund that it advises and to distribute the statement to investors within 45 days of the end of each quarter. The statements must include:

- Private fund-level disclosures, including adviser compensation, fund fees and expenses, offsets, rebates, and waivers;
- Portfolio investment-level disclosures, including portfolio investment compensation and ownership percentages;
- Information about the calculation methodology for fees and expenses, and cross references to relevant sections of the private fund's organizational and offering documents that set forth the methodology; and either:
 - For liquid funds, performance information including average, cumulative, and annual net total returns; or
 - For illiquid funds, performance information including gross and net internal rates of return, gross and net multiples of invested capital, aggregate contributions and distributions, and a statement of the fund's net asset value.

While many private fund advisers may already choose to voluntarily provide such statements to investors, there is currently no rule or enforcement mechanism compelling them to do so. In contrast, the Proposed Rules would formalize the quarterly statement requirement under the Advisers Act and standardize reporting so that investors have greater access to information and are able to find and compare information in an effective manner.

Private Fund Adviser Audits

The Proposed Rules include an "Audit Rule" requiring a registered investment adviser to provide and promptly distribute audited financial statements on an annual basis and upon liquidation. The SEC has yet to define what constitutes "prompt" distribution but is considering a 120-day time frame. Audits must be conducted by an independent public accountant in accordance with U.S. Generally

Accepted Auditing Standards (“U.S. GAAS”), and financial statements must be presented in accordance with U.S. Generally Accepted Accounting Principles (“U.S. GAAP”), or, in the case of foreign private funds, contain substantially similar information as required by U.S. GAAP.

Adviser–Led Secondaries

The Proposed Rules include an “Adviser–Led Secondaries Rule” imposing additional requirements before closing an investment with respect to certain adviser–led secondary transactions. In adviser–led secondary transactions where the adviser offers investors the option to sell their interests in the private fund or exchange their interests for new interests in another vehicle advised by the adviser, a registered investment adviser must:

- Obtain and distribute to investors a fairness opinion from an independent opinion provider, which must state that the price that the private fund adviser offers is fair; and
- Prepare and distribute to investors a written summary of any “material” business relationships between the adviser and the opinion provider in the last two years. Materiality is subject to interpretation, but the SEC has suggested that auditing, consulting, capital raising, investment banking, and other similar services would typically be considered material.

This disclosure requirement is aimed toward improving investors’ decision–making ability and confidence in the transaction, as well as protecting investors from possible conflicts of interest.

Preferential Treatment

The Proposed Rules include a “Preferential Treatment Rule” prohibiting all private fund advisers, *including those exempt from registration*, from engaging in the following activities:

- Seeking indemnification or otherwise limiting an adviser’s liability for breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund;

- Reducing the amount of any “adviser clawback” (i.e., the obligation to restore or return performance-based compensation to the private fund) by the amount of taxes applicable to the adviser;
- Charging fees for unperformed services (e.g., accelerated monitoring fees);
- Charging fees associated with a governmental or regulatory authority’s examination of the adviser or regulatory or compliance fees and expenses of the adviser;
- Charging fees and expenses related to investments that are charged on a non-pro rata basis among clients;
- Borrowing or receiving an extension of credit, money, securities, or other fund assets from a private fund client of the adviser;
- Providing preferential terms to certain investors regarding redemption or information about portfolio holdings or exposures; and
- Providing any other preferential treatment unless that treatment is disclosed to current and prospective investors. Specific terms, including reduced fee rates agreed upon with another investor, must be disclosed, but the investor’s information may be redacted.

These prohibitions aim to protect against potential conflicts of interest or preferential treatment that could harm investors.

In addition to the Proposed Rules, the SEC has also proposed amending Rule 204-2 under the Advisers Act (the “Books and Records Rule”). The proposed amendments to the Books and Records Rule would require advisers to private funds to retain books and records related to the proposed Quarterly Statement Rule, the proposed Audit Rule, the proposed Adviser-Led Secondaries Rule, and the proposed Preferential Treatment Rule.

The Proposed Rules do not contain any grandfathering provisions. Therefore, their requirements will likely apply to all private funds, and advisers thereto, on the date that such Proposed Rules go into effect. If adopted as proposed, advisers will be granted a one-year transition period from the effective date to comply with the new

and amended rules.

For more information concerning the Proposed Rules or other private fund topics, please contact any attorney in Frost Brown Todd's [Corporate Law](#) practice group.

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