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SEC Issues Long-Awaited Private Fund Adviser Rules

On August 23, 2023, the Securities and Exchange Commission (SEC) issued Release Number IA-6383, finalizing the long-anticipated expansion of its regulatory oversight of private investment funds and advisers to such funds (the “Private Fund Rules”). While a controversial subject, both from within the SEC as well as from the investment management industry as a whole, the new Private Fund Rules appear to have struck a tenuous balance between the SEC’s lofty goals of expanding its purview over private funds, their investors, and investment advisers, and the concerns of industry professionals who had previously enjoyed limited regulatory oversight of their endeavors involving private funds.

The new Private Fund Rules are designed to protect investors who directly or indirectly invest in private funds by:

- increasing transparency into private fund adviser compensation, sales practices, and conflicts of interest;
- establishing new and concrete compliance obligations for private fund advisers designed to reduce investor harm; and
- enhancing investor protection by restricting certain private fund adviser practices.

The new Private Fund Rules set forth seven key rule changes under the Investment Advisers Act of 1940 (the “Advisers Act”). While the following is by no means an exhaustive discussion of the new Private Fund Rules, as the release consists of a daunting 660 pages, it should nevertheless provide an overview of the release’s key requirements.

Rule Changes for All Registered Private Fund Advisers

Private Fund Audits: The new “Private Fund Audit Rule” mandates that registered private fund advisers ensure that each private fund it advises undergoes a financial statement audit that meets the requirements of the audit provisions outlined in the Advisers Act custody rule (Rule 206(4)-2). The intent behind this new rule, and

the audits it requires, is to provide a check on the adviser's valuation of private fund assets and to thereby protect private fund investors against the misappropriation of fund assets. It's important to note that such an audit requirement applies to funds both controlled and not controlled by the adviser so that the adviser takes reasonable steps to ensure the private fund undergoes an audit.

Quarterly Statements: The new "Quarterly Statement Rule" requires registered private fund advisers to distribute a quarterly financial statement to private fund investors. Each quarterly statement must include a series of tables that disclose both fund- and investment-level information regarding performance/returns, the cost of investing in the fund, fees and expenses paid by the fund, and compensation and other amounts paid to the adviser by the fund and its portfolio investments. For each private fund that is not a fund-of-funds, such statements must be provided within 45 days after the end of each of the first three fiscal quarters of each fiscal year of the private fund and 90 days after the end of each fiscal year. For each fund that is a fund-of-funds, such statements must be provided within 75 days after the end of the first three fiscal quarters of each fiscal year and 120 days after the end of each fiscal year, in either case, unless such a quarterly statement is prepared and distributed by another person.

Adviser-Led Secondaries: The new "Adviser-Led Secondaries Rule" requires registered private fund advisers to obtain a fairness opinion or a valuation opinion when offering existing fund investors the option between selling their interests in a private fund and converting or exchanging their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons. The Adviser-Led Secondaries Rule also requires an adviser to prepare and distribute to the fund's investors a summary of any material business relationships the adviser has or has had with the independent opinion provider, within the prior two years.

Books and Records: The new Private Fund Rules also include amendments to the books and records rules under the Advisers Act for registered private fund advisers. Such amendments include the requirement to document and retain evidence of an adviser's

compliance with its obligations pursuant to the new Private Fund Rules, including, but not limited to:

- copies of distributed quarterly and audited financial statements;
- documentation of steps taken to ensure that a private fund undergoes a financial audit;
- substantiation of the adviser's determination that a private fund client is a liquid fund or illiquid fund;
- copies of any fairness or valuation opinions and material business relationship summary pursuant to an adviser-led secondary transaction; and
- copies of any notification, consent or other document distributed or received pursuant to a private fund adviser restricted activity.

Rule Changes for All Private Fund Advisers

Restricted Activities: Under the new "Restricted Activities Rule," private fund advisers cannot engage in the following activities that are contrary to the public interest and the protection of investors.

- Charging or allocating fees or expenses to the private fund that are associated with an investigation of the adviser without disclosure and consent from fund investors; *provided, that*, an adviser may not charge 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 Advisers Act or the rules thereunder;
- Charging or allocating the adviser's regulatory, examination, or compliance fees or expenses to the private fund, unless such fees and expenses are disclosed to investors;
- Reducing the amount of an adviser clawback by the amount of certain taxes, unless the adviser discloses the pre- and post-tax amount of the clawback;
- Charging or allocating fees or expenses related to a portfolio investment on a non-pro rata basis, unless the allocation approach is fair and equitable, and the adviser distributes

advance written notice of the non-pro rata charge and a description of how the allocation approach is fair and equitable under the circumstances; and

- Borrowing or receiving an extension of credit from a private fund client without disclosure to, and consent from, fund investors.

Preferential Treatment: The new “Preferential Treatment Rule” prohibits all private fund advisers from providing preferential terms to investors regarding:

- certain redemptions from the fund, unless the ability to redeem is required by applicable law or the adviser offers the preferential redemption rights to all other investors without qualification; and
- certain preferential information about portfolio holdings or exposures, unless such preferential information is offered to all investors.

The Preferential Treatment Rule prohibits all private fund advisers from providing preferential treatment to investors unless such treatment is disclosed in accordance with the following:

- ***Advance written notice for prospective investors***: Prior to an investor’s investment in the private fund, a written notice must be provided disclosing any preferential treatment related to any material economic terms that the adviser provides to other investors in the same private fund.
- ***Written notice for current investors***: Either following the end of the private fund’s fundraising period (in the case of an illiquid fund) or following an investor’s investment in the private fund (in the case of liquid fund), an adviser is required to provide written disclosure of all preferential treatment the adviser has provided to other investors in the same private fund.
- ***Annual disclosure***: On at least an annual basis, an adviser must provide written notice regarding any new or amended preferential treatment they provided to other investors in the same private fund since the last written notice provided, if

any.

- **Particularity:** While advisers are permitted to redact identifying information when providing the above-noted disclosures, such disclosures must nonetheless be sufficiently detailed to include the particularities of any preferential treatment (e.g., if a management fee reduction has been granted to an anchor investor, the adviser must disclose the actual amount of the reduction as opposed to simply noting that such a reduction has been granted).

Rule Changes for All Registered Advisers

Compliance Procedures and Practices: The new Private Fund Rules amend the compliance procedures and practices rules under the Advisers Act, which now require all registered advisers, including those that do not advise private funds, to document in writing the required annual review of the adequacy, effectiveness, and implementation of their compliance policies and procedures, including with respect to the new Private Fund Rules. The SEC believes a written annual review is helpful for determining an adviser's compliance with their obligations under the Advisers Act rules, but also to identify potential weaknesses in an adviser's compliance program.

Compliance Timeline

For the Private Fund Audit Rule and the Quarterly Statement Rule, the compliance date will be 18 months after the date of publication of the release in the Federal Register.

For the Adviser-Led Secondaries Rule, the Preferential Treatment Rule, and the Restricted Activities Rule, the compliance dates are:

- for advisers with \$1.5 billion or more in private funds assets under management, 12 months after the date of publication of the release in the Federal Register; and
- for advisers with less than \$1.5 billion in private funds assets under management, 18 months after the date of publication of the release in the Federal Register.

Compliance with the amended Advisers Act compliance rule will be required 60 days after the release is published in the Federal Register.

The SEC is providing legacy status for the prohibitions aspect of the Preferential Treatment Rule and the aspects of the Restricted Activities Rule that require investor consent. The legacy status provisions apply to governing agreements that were entered into prior to the compliance date if the applicable rule would require the parties to amend the agreements; *provided, that*, such legacy status will be limited to material terms that do not otherwise lend themselves to amendment (e.g., preferential redemption rights). Terms that are otherwise easily modified to become applicable to all investors *pari passu* (e.g., informational rights) will not enjoy such legacy status. A determination of which specific terms may be eligible for definitive legacy treatment will likely be the subject of ongoing analysis.

Legal Challenges

On September 1, 2023, a challenge to the Private Fund Rules was filed in the U.S. Court of Appeals for the Fifth Circuit on behalf of several industry organizations (the “Petition for Review”) claiming that:

- the SEC exceeded its statutory authority in adopting the Private Fund Rules without compliance with notice-and-comment requirements; and
- the Private Fund Rules are otherwise arbitrary, capricious, an abuse of discretion, and contrary to law, all in violation of the Administrative Procedure Act and the SEC’s heightened obligation to consider its rules’ effect on “efficiency, competition, and capital formation” under the Advisers Act.

We will continue to monitor this Petition for Review, as well as any subsequent challenges and other developments impacting the implementation and compliance timeline of the Private Fund Rules, going forward.

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

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