

Vinson&Elkins

Private Fund Adviser Rules:

An Overview for Private Equity Managers

September 2023

Brief History

- On August 23, 2023, the SEC adopted final rules for investment advisers to private funds.
- The SEC first proposed private fund rules in February 2022. V&E contributed to comment letters by the American Investment Council (AIC) and the NYC Bar Private Investment Funds Committee.
- The final rules do not include or modified some of the most aggressive proposals, but nonetheless impose far-reaching requirements on fund managers.
- On September 1, 2023, the AIC and a number of other industry organizations filed a lawsuit against the SEC, claiming that it exceeded its statutory authority and acted arbitrarily and capriciously in adopting the new rules.

Scope of New Rules

All Investment Advisers to Private Funds	Only Registered Investment Advisers to Private Funds
Prohibitions or Disclosure / Consent Requirements:	Affirmative Obligations:
<ul style="list-style-type: none"> • Restricted Activities <ul style="list-style-type: none"> – Regulatory, Compliance & Examination Expenses – Reducing Clawback for Taxes – Non-Pro Rata Fee and Expense Allocations – Investigation Expenses – Borrowing • Preferential Treatment <ul style="list-style-type: none"> – Redemptions – Transparency 	<ul style="list-style-type: none"> • Quarterly Statements <ul style="list-style-type: none"> – Fund Fees and Expenses – Portfolio Investment Payments to Adviser – Fund Performance • Private Fund Audits • Fairness or Valuation Opinion in Adviser-Led Secondaries (Continuation Funds)
	<ul style="list-style-type: none"> • Documentation of Annual Compliance Review

Key Terms

- Private Fund** = An issuer that relies on the exemption provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act.
- Private funds do not include, among others:*
- funds that invest directly in real estate and not in securities;
 - real estate funds that rely on the exemption provided by Section 3(c)(5)(C) of the Investment Company Act; and
 - oil, gas and minerals funds that rely on the exemption provided by Section 3(c)(9) of the Investment Company Act.
- Related Persons** = (1) Officers, partners, and directors of the adviser; (2) persons controlling or controlled by, or under common control with, the adviser; and (3) employees, other than those performing administrative functions.
- Illiquid Fund** = A fund that is not required to redeem interests upon an investor's request and has limited or no opportunities for investors to withdraw.
- Basically, all private equity funds are illiquid funds and all or most hedge funds are liquid funds. This overview does not address liquid fund rules.*
- Similar Pool of Assets** = A pooled investment vehicle with investment objectives substantially similar to those of a private fund managed by the adviser or its related persons.
- Beyond parallel funds, this includes co-investment vehicles and possibly funds with related industry focus (e.g., energy and infrastructure), but not separately managed accounts (SMAs).*

Restricted Activities

Investment Adviser May Not...	Unless...
<ul style="list-style-type: none"> Charge to the private fund fees and expenses associated with a governmental or regulatory investigation of the adviser or its related persons. 	<ul style="list-style-type: none"> The adviser distributes a written notice to all investors and obtains written consent from a majority in interest of the investors that are not related persons.
<ul style="list-style-type: none"> <i>The rule applies to all governmental investigations, not just those by the SEC.</i> <i>The consent requirement applies even if the fund agreement provides for indemnification of the adviser.</i> <i>The SEC did not provide any guidance on expense delineation if both a fund and the adviser are targets of an investigation.</i> 	
<ul style="list-style-type: none"> Charge to the private fund fees and expenses related to an investigation that results or resulted in a court or governmental sanction for violation of the Investment Advisers Act or rules thereunder. 	<ul style="list-style-type: none"> N/A
<ul style="list-style-type: none"> <i>This is an absolute prohibition, regardless of fund terms or investor consents.</i> 	
<ul style="list-style-type: none"> Charge to the private fund any regulatory or compliance (including examination) fees or expenses of the adviser or its related persons. 	<ul style="list-style-type: none"> The adviser distributes a written notice of such fees and expenses, including their amount, to all investors within 45 days after the end of the fiscal quarter in which the charge occurs.
<ul style="list-style-type: none"> <i>The ability to charge compliance fees and expenses to the fund depends first on the terms of the fund agreement. Even if the fund agreement permits the charge, the notice requirement applies.</i> <i>The notice requirement does not apply to compliance fees and expenses of the fund itself (e.g., Securities Act or Securities Exchange Act filings).</i> 	

Restricted Activities

Investment Adviser May Not...	Unless...
<ul style="list-style-type: none"> Reduce any clawback by any actual, potential or hypothetical taxes. 	<ul style="list-style-type: none"> The adviser distributes a written notice to all investors, with the clawback amount before and after taxes, within 45 days after the end of the fiscal quarter in which the clawback occurs.
<ul style="list-style-type: none"> <i>This seems to have limited or only incremental impact, as PE firms typically provide this information if a clawback obligation arises.</i> 	
<ul style="list-style-type: none"> Charge fees or expenses related to an actual or potential portfolio investment on a non-pro rata basis when multiple funds or entities advised by the adviser or its related persons invested or propose to invest in the same investment. 	<ul style="list-style-type: none"> The non-pro rata charge is fair and equitable, and Prior to the charge, the adviser distributes to all investors a written notice of the charge and a description of how it is fair and equitable.
<ul style="list-style-type: none"> <i>What is fair and equitable will depend on the facts and circumstances. An example are incremental expenses associated with a bespoke structuring arrangement.</i> <i>The rule, and the related guidance by the SEC, do not distinguish between broken deals and consummated deals. It would seem generally not fair and equitable to allocate broken deal expenses solely to the fund after another fund or co-investor has made a commitment to participate in the deal.</i> 	

Restricted Activities

Investment Adviser May Not...	Unless...
<ul style="list-style-type: none">• Borrow from a private fund.	<ul style="list-style-type: none">• The adviser distributes a written notice to all investors and obtains written consent from a majority in interest of the investors that are not related persons.
<ul style="list-style-type: none">• <i>Tax distributions to the general partner that are treated as advances on carried interest distributions are not subject to the notice and consent requirement. However, tax distributions may be subject to the notice and consent requirement if structured as a loan with an outright repayment obligation, even if permitted by the fund agreement.</i>	

Preferential Treatment: Summary

Investment Adviser May Not...	Except if... / Unless...
<ul style="list-style-type: none"> Grant redemption rights to an investor in a private fund or similar pool of assets on terms the adviser reasonably expects to have a <u>material, negative effect</u> on other investors in the fund or similar pool of assets. 	<ul style="list-style-type: none"> Redemption right is required by applicable laws or regulations, or Redemption right is offered to all other existing and future investors.
<ul style="list-style-type: none"> Provide information on portfolio holdings of a private fund or similar pool of assets if the adviser reasonably expects it would have a <u>material, negative effect</u> on other investors in the fund or similar pool of assets. 	<ul style="list-style-type: none"> Information is provided to all other existing investors at the same or substantially same time.
<ul style="list-style-type: none"> Provide any preferential treatment to any investor in a private fund (aka “Side Letter Rule”, but the rule also applies to informal arrangements that grant preferential rights). 	<ul style="list-style-type: none"> The adviser provides written notice to each prospective investor, <u>prior to</u> its investment, of any preferential treatment related to any <u>material economic</u> terms granted in the same fund. For an illiquid fund, as soon as reasonably practicable after the end of the fundraising period, the adviser distributes written disclosure of all preferential treatment. On at least an annual basis, the adviser distributes written notice of any preferential treatment provided since the last written notice.

Preferential Treatment: Practical Questions

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| <ul style="list-style-type: none">• Do the limitations on redemption rights and information on portfolio holdings impact PE firms? <p>⇒ <i>While they are mainly targeted at hedge funds, they can impact PE firms because of their extension to similar pools of assets, for example, when an investor in a co-investment vehicle has additional redemption or information rights.</i></p> |
| <ul style="list-style-type: none">• What are “material economic terms” for which advance notice must be given to prospective investors? <p>⇒ <i>Certainly management fee and carry discounts, but also preferential liquidity rights and co-investment rights.</i></p> |
| <ul style="list-style-type: none">• Does the common practice of providing a side letter compendium to investors after the final closing meet the new disclosure requirements? <p>⇒ <i>Yes, so long as the compendium is provided to all investors (and not just those with MFN rights), describes all preferential treatment specifically, and is provided soon (the SEC indicated that would typically mean within four weeks). Electronic delivery or posting to a virtual data room is sufficient. Absent further guidance from the SEC, the disclosure requirement also seems to apply to funds that closed in the past or before the compliance date.</i></p> |
| <ul style="list-style-type: none">• For closed-end funds, are there situations that can trigger the annual updating notice? <p>⇒ <i>Yes, for example, when a transferee of a fund interest negotiates a new side letter.</i></p> |

Quarterly Statements

Format & Contents	Refinements
<ul style="list-style-type: none"> Within 45 days after the end of each of the first three fiscal quarters and 90 days after the end of each fiscal year. 	
<p><u>Fund Table:</u></p> <ul style="list-style-type: none"> All compensation, fees and other amounts allocated or paid to the adviser or any of its related persons. All fees and expenses allocated to or paid by the fund. Any offsets or rebates carried forward. 	<ul style="list-style-type: none"> Before and after the application of any offsets, rebates or waivers. Separate line item for each category. Disclosure of calculation methods and cross-references to the sections of the offering or governing documents that set forth the methodology.
<p><u>Portfolio Investment Table:</u></p> <ul style="list-style-type: none"> All portfolio investment compensation allocated or paid to the adviser or any of its related persons. 	<ul style="list-style-type: none"> Monitoring and similar fees must be reported even when they offset management fees in full. Examples of portfolio investment compensation typically not subject to offsets are acquisition or property management fees paid to an adviser of real estate funds.
<p><u>Performance (for Illiquid Funds):</u></p> <ul style="list-style-type: none"> Gross IRR and Gross MOIC. Net IRR and Net MOIC. Gross IRR and Gross MOIC for the realized and unrealized portfolio. Statement of contributions and distributions, including the net asset value of the fund. 	<ul style="list-style-type: none"> Since inception of the fund. With and without the impact of any fund-level subscription facility. Disclosure of criteria and assumptions used, including fee rates used to calculate net performance.

Audit & Adviser-Led Secondaries: Requirements

- Annual private fund audit that meets the audit requirements of the custody rule under the Investment Advisers Act.

⇒ *Limited practical impact, as most PE firms already provide audited financial statements.*

- Prior to the due date of the election form in respect of an adviser-led secondary transaction:
 - fairness opinion or valuation opinion from an independent opinion provider; and
 - written summary of any material business relationships with the opinion provider during the prior two years.

⇒ *Limited practical impact, as market practice has become to obtain a fairness opinion in continuation fund transactions.*

Compliance Dates

Rules	Larger Advisers (Private Fund AUM \geq \$1.5 bil)	Smaller Advisers (Private Fund AUM < \$1.5 bil)
<u>All Advisers to Private Funds</u>	12 months	18 months
• Restricted Activities		
• Preferential Treatment	12 months	18 months
<u>Registered Advisers to Private Funds</u>		
• Quarterly Statements	18 months	18 months
• Audit	18 months	18 months
• Adviser-Led Secondaries	12 months	18 months
• Annual Compliance Review	60 days	60 days

The transition periods start with the publication of the new rules in the Federal Register, which is expected shortly.

Legacy Status (Grandfathering)

- The new rules grant very **limited legacy status** to existing funds and their governing agreements:
 - only for agreements (including side letters) of funds that commenced operations as of the compliance date;
 - only for terms that grant special rights and would typically have to be amended as a result of the new rules:
 - Preferential redemption rights
 - Preferential information rights
 - Right to borrow from fund
 - Right to charge fund for fees and expenses related to investigations, but (i) only if fees and expenses are disclosed in accordance with the new rules and (ii) not for fees and expenses related to an investigation that results or resulted in a court or governmental sanction for violation of the Investment Advisers Act or the rules thereunder.
- **No legacy status** for contractual or side letter provisions that are subject to new disclosure-based rules. For example, preferential side letter provisions granted before the compliance date must be disclosed to new investors after the compliance date.



Disclaimer

This presentation was created to provide an overview of the new SEC rules for investment advisers to private funds. This is a broad summary not intended to cover every aspect of the rules.

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Robert Seber is head of our Investment Management practice. He is highly experienced in the full cycle of private equity funds, including fund formation, carry and equity arrangements, governance, investments, and exits, and has a profound knowledge of market trends. He has formed multiple energy and infrastructure funds with innovative terms that reflect the nuances of investments in these industries. Robert also represents companies and investors in financial services industries.

Robert is an adjunct professor of law at New York University School of Law, where he teaches a class on energy transition. He is a frequent panelist on private equity and energy policy topics. And he likes to run up mountains.

