What Do the SEC's New Private Fund Rules Mean For Real Estate Fund Managers?


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On Aug. 23, 2023, the US Securities and Exchange Commission (SEC) adopted sweeping final rules and amendments (Final Rules) under the Investment Advisers Act of 1940 that will impose additional obligations and restrictions on advisers to private funds effective Nov. 13, 2023.[1] The Final Rules include several different rules that will apply to varying degrees to private fund advisers that are SEC-registered investment advisers (RIAs) and those that are exempt from registration. For example, the Quarterly Statement Rule (Rule 211(h)(1)-2), the Audit Rule (Rule 206(4)-10), and the Adviser-Led Secondaries Rule (Rule 211(h)(2)-2) apply to RIAs to private funds, and the Restricted Activities Rule (Rule 211(h)(2)-1) and the Preferential Treatment Rule (Rule 211(h)(2)-3) apply to all advisers to private funds.[2] Each individual rule is discussed below in greater detail.

Scope of the Rules and Commercial Implications For Real Estate Funds and Managers

For purposes of the Final Rules, a "private fund" is an issuer that would be an "investment company" but for the exceptions provided in Section 3(c)(1) (which allows for 99 or fewer accredited investors[3] to beneficially own interests) or 3(c)(7) (which permits only qualified purchasers[4] to invest) of the Investment Company Act of 1940, as amended.[5] Accordingly, the Final Rules generally will not impact an adviser of a real estate fund that is not an investment company as defined under the Investment Company Act or a fund that relies on other exceptions (notably, Section 3(c)(5)(C) or Section 3(c)(6)). Many real estate fund advisers have already made these assessments as part of categorizing their funds for purposes of Form ADV and Form PF, but the new Final Rules will provide another strong incentive to conclude that funds do not need to rely on Section 3(c)(1) or 3(c)(7) to avoid being categorized as private funds. As a general matter, most open-end core funds will not come within the definition of investment company at all, and many closed-end equity and debt funds will be able to rely on Section 3(c)(5)(C). However, each fund must be separately assessed based on its particular facts and circumstances, and many value-added and opportunistic funds and open-end debt funds are commonly treated as private funds.

The Final Rules may impact certain advisers with respect to a subset of their products—for example, an adviser may conclude that some of its funds are private funds and others are not. Moreover, many real estate fund advisers are part of larger organizations that offer all kinds of commingled products across their entire investor base, many or most of which may be private funds. Although these advisers will have a clear technical basis to avoid application of the Final Rules to certain funds or business lines, as a commercial matter, offering products on the same platform with and without the features the Final Rules will require likely will be difficult, and those commercial challenges may increase over time as investors become more accustomed to some of the standardized reporting and side letter disclosures.

Impact of New SEC Guidance

In adopting the Final Rules, the SEC generally shifts aspects of the various rules from a prescriptive approach prohibiting certain conduct or activities (which was the case under the original proposal) to a disclosure-based approach consistent with the historical approach to

1. "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews," Adopting Release, SEC.
2. All rule references refer to rules adopted under the Advisers Act.
3. As defined in Rule 501 under the Securities Act of 1933, as amended.
4. As defined in Section 2(a)(51) under the Investment Company Act.
5. The Final Rules exclude private funds that are "securitized asset funds" from application of the new rules. This generally includes collateralized loan obligations, so this exclusion does not generally provide any benefit to real estate funds.

regulation under the Advisers Act. Although the SEC ultimately declined to prohibit certain activities under the Restricted Activities Rule, it provides important guidance as part of this change that has the effect of calling into question—or implicitly banning—the practices it declined to prohibit by rule.

Notably, the SEC unambiguously views an adviser charging fees to a fund's portfolio investment for fees in respect of services that the adviser does not (or does not reasonably expect to) provide to the portfolio investment as inconsistent with an adviser's fiduciary duty. Additionally, the SEC provides guidance that an adviser may not seek reimbursement, indemnification, or exculpation for breaching its federal fiduciary duty because such reimbursement, indemnification, or exculpation would operate effectively as a waiver, which would be invalid under the Advisers Act.

Restrictions Applicable to All Private Fund Advisers

The Final Rules will restrict certain activities that the SEC believes involve conflicts of interest and compensation schemes that are contrary to the public interest. Generally, such activities may be engaged in only with disclosure to and, in some instances, consent from investors.

The Restricted Activities Rule

Under the Restricted Activities Rule, an adviser may charge or allocate to a private fund

- *fees and expenses related to an investigation of the adviser or related persons by a governmental or regulatory authority only if the adviser gives prior written notice to all investors and obtains prior written consent from at least a majority in interest of third-party investors*
- *regulatory and compliance fees or expenses or fees or expenses associated with an examination of the adviser or related persons only if the adviser provides itemized written notice to investors of such fees or expenses*
- *certain fees or expenses related to the same portfolio investment on a non-pro-rata basis provided the non-pro-rata allocation is "fair and equitable" and the adviser furnishes prior written notice to investors of the non-pro-rata allocation along with an explanation of how such allocation is fair and equitable*

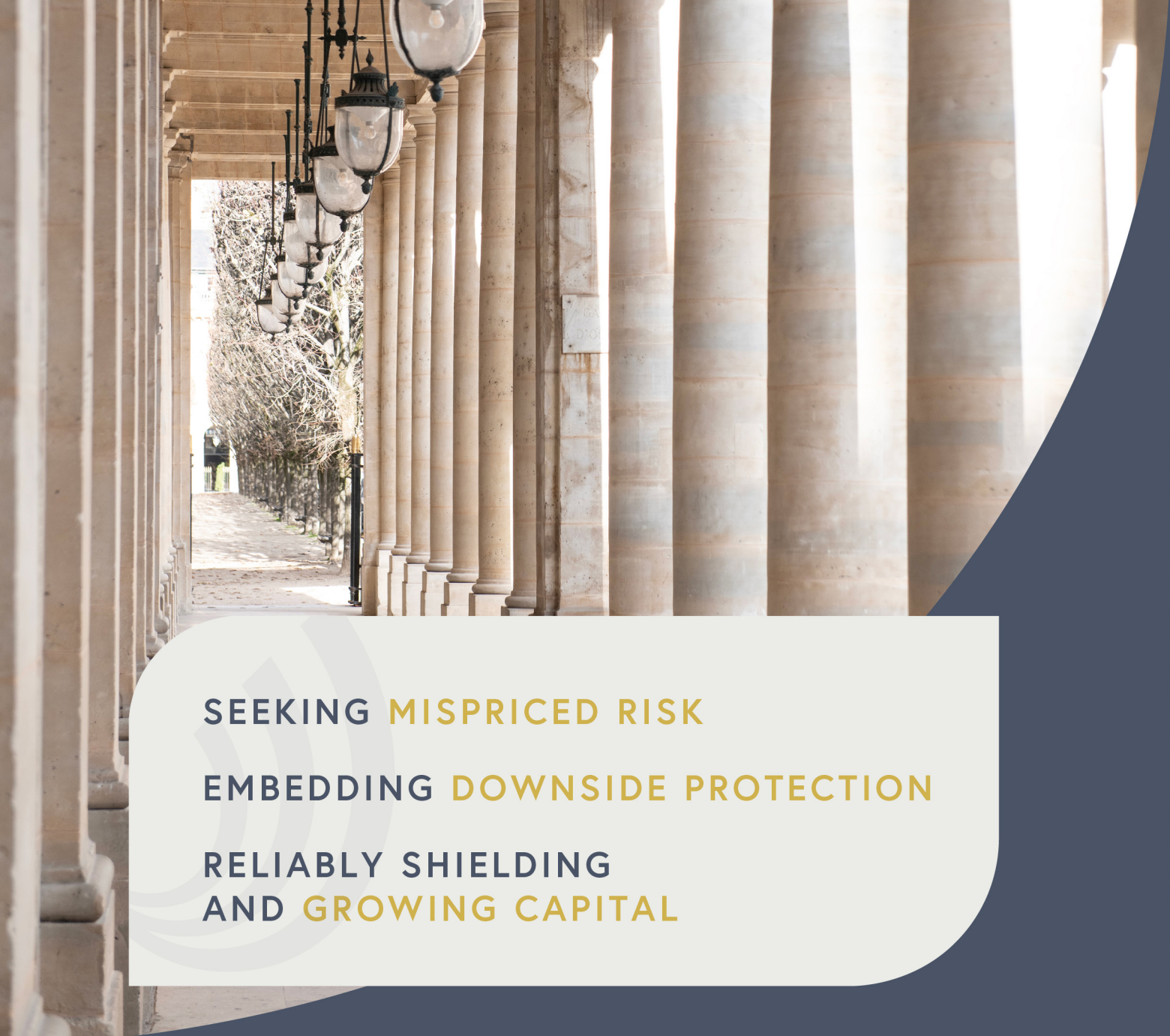
An adviser cannot charge fees or expenses related to an investigation that results in a sanction for a violation of the Advisers Act.

The Restricted Activities Rule will allow an adviser to reduce the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser or its related persons, as long as written notice reflecting the pre-tax and post-tax clawback amounts is distributed to the investors.

Finally, the Restricted Activities Rule will prohibit an adviser from borrowing cash, securities, or other assets from a private fund client without first disclosing the material terms of such borrowing and obtaining the consent of the fund's investors.

The Preferential Treatment Rule

The Preferential Treatment Rule has two components: prohibitions on the granting of certain liquidity rights



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or information and disclosure of all forms of preferential treatment (e.g., side letters). Taken together, this aspect of the Final Rules will likely have a significant impact on market practices. With respect to the prohibitions, an adviser may not grant a private fund investor preferential liquidity or information rights if such rights would have a material, negative effect on other investors in the private fund. These prohibitions apply to both the private fund itself and any "similar pool of assets"—i.e., a pooled investment vehicle, other than a fund registered under the Investment Company Act, with substantially similar investment policies, objectives, or strategies to those of the fund managed by the same adviser or its affiliates.

The Preferred Treatment Rule will provide these two exceptions to the ban on preferential liquidity rights:

1. *if the right to redeem is required to comply with applicable laws, rules, or regulations*

2. *if the adviser has offered and will offer the same rights to all existing and future investors*

The second part of the Preferential Treatment Rule will prohibit an adviser to a private fund from directly or indirectly providing any preferential treatment to any investor in the private fund unless the adviser provides certain pre- and post-investment notices to prospective and current investors in the same private fund. Prior to its investment, the adviser must provide specific information regarding any preferential treatment related to any "material economic terms" provided to other investors in the same private fund. In addition, disclosure of all preferential treatment must be provided to current investors in an illiquid fund[6] as soon as reasonably practicable following the end of the fundraising period (generally, within four weeks). Investors in a liquid fund must receive disclosure of all preferential treatment within four weeks of making an investment in the fund. Last, all investors must receive updated disclosure of preferential treatment on an annual basis.

Notably, these disclosure requirements will also apply to existing funds, including funds that no longer admit new investors or are past their investment periods. These new requirements will undoubtedly have a significant impact on side letter practices through the private fund market, based on the radical increase in transparency of side letter arrangements.

Additional Requirements Applicable to RIAs

In connection with an "adviser-led secondary transaction," the Adviser-Led Secondaries Rule will require all RIAs to private funds to

- *obtain a fairness opinion or valuation opinion from an "independent opinion provider"*[7]
- *prepare a written summary of "material business relationships"*[8] *that the adviser or related persons has (or had) with the independent opinion provider during the prior two years*
- *distribute the opinion and written summary to all investors prior to the due date of the election form for such transaction*

For these purposes, an adviser-led secondary transaction is a transaction initiated by the adviser or any of its related persons that offers the private fund's investors the choice between (1) selling all or a portion of their interests in the private fund and (2) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the RIA or any of its related persons.

Under the Quarterly Statement Rule, RIAs to private funds will be required to provide quarterly statements to investors within certain time periods after each fiscal quarter end that describe fees and expenses of the fund and its portfolio companies and include specified performance metrics. We expect that meeting the required deadlines (within 45 days of quarter end for the first three fiscal quarters and 90 days for the fourth fiscal quarter for most funds) will be a significant operational challenge for many fund sponsors.

The Final Audit Rules will require advisers registered with, or required to be registered with, the SEC to cause the private funds they advise to undergo audits in accordance with the requirements set forth in the Custody Rule.

Finally, the Final Rules will amend the Compliance Rule to require all RIAs, including RIAs that advise no

6. An "illiquid fund" is a fund that is not required to redeem interests upon an investor's request and has limited opportunities, if any, for investors to withdraw before termination of the fund. A "liquid fund," in contrast, is any fund that is not an illiquid fund. Generally, closed-end funds will be considered illiquid funds, and open-end funds will be considered liquid funds.

7. Final rule 211(h)(1)-1, "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews," Adopting Release, SEC, p. 614.

8. "Private Fund Advisers," p. 199.

Exhibit 1: Final Rules Transition Period Summary

Rule	Who Is Covered	Larger* Private Fund Advisers Compliance Dates	Smaller Private Fund Advisers Compliance Dates	Legacy Treatment;† Other Notes
Rule 211(h)(1)-2 Quarterly Statement Rule	RIAs	18 Months—3/14/2025	18 Months—3/14/2025	None
Rule 206(4)-10 Audit Rule	RIAs	18 Months—3/14/2025	18 Months—3/14/2025	None
Rule 211(h)(2)-1 Restricted Activities Rule	All Advisers	12 Months—9/14/2024	18 Months—3/14/2025	Legacy treatment only for (a) aspects that require investor consent, e.g., adviser borrowing from a fund, and (b) charges for certain investigation fees and expenses. No need to amend organizational or borrowing documents entered into prior to compliance.
Rule 211(h)(2)-2 Adviser-Led Secondaries Rule	RIAs	12 Months—9/14/2024	18 Months—3/14/2025	None
Rule 211(h)(2)-3 Preferential Treatment Rule	All Advisers	12 Months—9/14/2024	18 Months 3/14/2025	Legacy treatment only for (a) preferential redemption rights and (b) information rights about portfolio holdings. No need to amend organizational documents or contractual arrangements entered into prior to compliance.
Rule 206(4)-7(b) Amended Compliance Rule	All Advisers (Even Without Private Funds)	60 Days—11/13/2023	60 Days—11/13/2023	All advisers must document, in writing, their next review commenced within the 12 months following compliance date

Source: Mayer Brown LLP

* For compliance purposes, the SEC has split investment advisers into two categories: Larger Private Fund Advisers with $1.5 billion dollars or more in private fund assets under management and Smaller Private Fund Advisers with less than $1.5 billion dollars in private fund assets under management.

† Legacy status applies only to private funds that commenced operations as of the compliance date.

private funds at all, to review and document in writing, at least annually, the adequacy of their compliance policies and procedures and the effectiveness of their implementation.

Transition Period for Compliance

Exhibit 1 summarizes the transition period for each component of the Final Rules. As noted in the exhibit, the SEC will provide limited grandfathering (termed "legacy treatment") for existing funds that have terms or side letters that would otherwise conflict, in certain narrowly tailored ways, with the Restricted Activities Rule and the Preferential Treatment Rule. (Notably, this treatment does not excuse any disclosure requirements.)

Conclusion

The Final Rules clearly will have a significant impact on the private fund landscape, as fund sponsors and investors alike grapple with both the immediate changes and the second-order effects over the months and years to come. RIAs should consider reviewing their policies and procedures to determine whether changes should be implemented, both to ensure compliance with the Final Rules and to adhere to industry best practices. ■

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