

On August 23, 2023, the Securities and Exchange Commission (SEC) adopted new rules and amendments to the Investment Advisers Act of 1940 that significantly affect the operations of private fund managers. While the new regulations do not directly affect broker/dealers, the changes affect many of our clients and it is important to understand how they may affect how they approach transactions. Below are the primary ways the new regulations may alter how we interact with private fund managers.

1. Increased scrutiny on side letters. The new regulations require fund managers cannot give preferential treatment to certain investors that has negative, material impact on the on the other investors in the fund. Negative material impact on investors could include an increased burden of operational costs on a pro rata basis, unequal information distribution, and/or unequal redemption terms. Since the focus is on the material impact on the fund investors, it is unlikely side letters that alter carried interest or distributions to the manager are in any way affected. However, If a manager wishes to offer variable management fees, operation fees, etc., they must disclose this to all current and prospective investors. This limits the viability of altering the terms of an offering to bring in large investors, but still offers a path forward to facilitate such transactions.
2. Fairness Opinions. To facilitate an advisor-led secondary process, the manager must obtain a third-party fairness or valuation opinion. The opinion must be distributed to investors prior to such a process. This is a serious impediment to facilitating an advisor led secondary process. Not only is a fairness opinion an expensive process, but it in turn opens additional scrutiny to the fund's marks and may cause operational headaches and disruption. In turn, this creates value for a broker to bring to a LP secondary process. Since the regulations only apply to advisor-led secondaries, brokers can facilitate LP secondary transactions in a more efficient manner than an internal process.
3. Annual Audit: Funds must obtain an annual independent financial statement audit of each private fund they advise that meets the requirements of the audit provision in the Advisers Act Custody Rule (Rule 206(4)-2)) by a public accountant. While not necessarily an impediment, this is additional cost and headache associated with operation of a SPV that ultimately raises the cost of such a structure.