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New SEC rules for private fund managers: implications for offshore investment advisers

BY JOHN HUNT

In August 2023, the US Securities and Exchange Commission (SEC) adopted highly anticipated new rules and amendments – the Private Funds Rules – to the US Investment Advisers Act of 1940 (Advisers Act). The Private Funds Rules, when fully effective, will significantly impact how investment advisers – both those registered with the SEC and those unregistered – manage and administer private funds, such as hedge funds, private equity (PE) funds, real estate PE funds and venture capital funds.

The focus of the Private Funds Rules, as with the Advisers Act generally, is US-based investment advisers. The Private Funds Rules, however, also may apply to offshore investment advisers, that is, investment

advisers whose primary office and place of business is located primarily outside of the US. While the implications of the Private Funds Rules may be limited with respect to many offshore investment advisers, those implications are not particularly obvious. This article focuses on potential implications of the Private Funds Rules specifically to offshore investment advisers.

Brief overview of the Private Funds Rules

US regulation of a private fund is primarily indirect regulation through the regulation of the fund's investment adviser under the Advisers Act. This arrangement is similar to the EU's regulation of an alternative investment fund (AIF). Under the EU's Alternative Investment Fund Managers

Directive, an AIF is regulated indirectly by regulation of the AIF's alternative investment fund manager (AIFM). The Private Funds Rules significantly broadened those US rules applicable to an investment adviser with private fund clients, especially if the investment adviser is registered with the SEC.

Under the Advisers Act, a private fund is a fund that satisfies and relies on the conditions of section 3(c)(1) or section 3(c)(7) of the US Investment Company Act of 1940 (1940 Act) for an exclusion from the 1940 Act's definition of an investment company. Most issuers that are investment companies are required to register as such and comply with most provisions of the 1940 Act. Section 3(c)

(1) provides that an issuer is excluded from that definition if it does not make a public offering of securities and it limits the number of investors in the fund to 100 (or 250 investors in the case of certain venture capital funds). Section 3(c)(7) provides that an issuer is excluded if does not make a public offering of securities and all investors are “qualified purchasers”. A private fund would include most types of hedge funds, PE funds and venture capital funds. Other types of funds, such as mutual funds, exchange-traded funds (ETFs) and closed-end funds traded on an exchange, as well as certain types of real estate funds, are not. Importantly, securitised asset funds are specifically excluded from the Private Funds Rules even if they are relying on section 3(c)(1) or section 3(c)(7).

Those Private Funds Rules that apply only to SEC-registered investment advisers to private funds are: (i) a requirement to have independent audits of the fund’s annual financial statements that are prepared in accordance with US GAAP; (ii) a requirement to distribute quarterly reports to shareholders that include a table of fund fees and expenses, a table of portfolio holdings, and a presentation of fund-level standardised performance information, with special rules applicable to “liquid funds”, such as hedge funds, and “illiquid funds”, such as PE funds; and (iii) requirements applicable to adviser-led secondary transactions to obtain and distribute either a fairness opinion or a valuation opinion from an independent opinion provider.

Those Private Funds Rules that apply to all investment advisers to private funds – SEC-registered and unregistered – and which are commonly referred to as the ‘Restricted-Activities Rules’, prohibit: (i) charging or allocating to funds fees and expenses associated with government investigations of the investment adviser without disclosure or investor consent; (ii) charging or allocating to funds fees and expenses associated with investigations that result in a court order or government-imposed sanctions, with no disclosure or investor-consent exceptions; (iii) charging or allocating to funds the adviser’s regulatory, examination and compliance fees and expenses without quarterly notice

of the fee and expense amounts; (iv) charging or allocating to funds expenses relating to a portfolio investment on a non-pro rata basis, unless the approach is fair and equitable and disclosed to investors; (v) reducing the amount of an investment adviser’s clawback by actual, potential or hypothetical taxes without certain disclosure and without quarterly notice of the amounts of the reductions; and (vi) borrowing private fund client assets or receiving a loan or an extension of credit from a private fund client, without disclosure and investor consent.

Finally, those Private Funds Rules that apply to all investment advisers to private funds – SEC-registered and unregistered – and which are commonly referred to as the ‘Preferential-Treatment Restrictions’, prohibit private fund advisers from providing some, but not all, investors with: (i) preferential redemption rights, unless the rights are required by applicable law, or the adviser offers the rights to other investors without qualification; (ii) preferential information rights about portfolio holdings or exposure, unless offered to all investors; and (iii) other preferential treatment to one or more private fund investors, unless certain preferential terms are disclosed in advance of the investor’s investment, and all terms are disclosed after the investor’s investment.

In the Private Funds Rules adopting release, the SEC also said that the Restricted-Activities Rules and the Preferential-Treatment Restrictions would not apply to offshore unregistered investment advisers with respect to their offshore funds regardless of whether the funds have US investors.

Certain practical considerations for an offshore investment adviser with its primary office and place of business outside of the US

In light of the foregoing, there are some key considerations for offshore investment advisers.

First, US-based investment advisers, of course, are subject to the Advisers Act, which now includes the Private Fund Rules, regardless of whether the private funds they manage are organised under the laws of

the US, typically Delaware, or an offshore jurisdiction, such as the Cayman Islands, Luxembourg or Ireland.

Second, offshore investment advisers whose primary office and place of business is outside of the US, and whose only US activity is offering shares of offshore funds to US investors, will continue to remain outside of the substantive provisions of the Advisers Act. The SEC has confirmed in the adopting release to the Private Funds Rules that it would continue to follow its longstanding position with the Private Funds Rules. Importantly, the SEC also has said that it would apply the same principle to unregistered and exempt offshore investment advisers. Offshore investment advisers to US private funds, however, would be subject to the Private Funds Rules, the extent to which being dependent on whether the offshore investment adviser is registered with the SEC or unregistered or exempt.

Third, an offshore investment adviser that has a US investment advisory subsidiary or other US operations may be subject to the Advisers Act, and by extension the Private Funds Rules. However, the extent to which the Advisers Act applies to an offshore investment adviser with a US subsidiary or operations will depend on the relationships of the offshore entity with the US subsidiary and other operations. The applicability of the Advisers Act to these types of relationships has been extensively discussed by the SEC and its staff in no-action letters and other guidance. Nothing in the Private Funds Rules or their adopting release suggests that guidance has changed.

Fourth, if an offshore investment adviser to an offshore fund engages a US investment adviser (whether a subsidiary of the offshore investment adviser or otherwise) as a sub-adviser to the offshore fund, the offshore fund is likely to be subject to the Private Funds Rules. As a result, it will be important for the offshore investment adviser and the US sub-adviser to delineate their compliance with the Advisers Act, including the Private Funds Rules, prior to launching the fund.

Fifth, the Private Funds Rules only apply to the regulation of the investment advisers to private funds. All offshore funds with US

investors will be expected to continue to comply with the 1940 Act (which regulates ‘investment companies’), as well as the US Securities Act of 1933 (which regulates the offer and sale of securities and includes Regulations D and S), in each case, at least with respect to its US investors. The prohibitions of the Employee Retirement Income Security Act of 1974 (ERISA) – which regulates transactions between pension plans and their fiduciaries – also will continue to apply if the assets of the offshore fund are ERISA plan assets.

Sixth, offshore investment advisers to US private funds (which are subject to the Private Funds Rules) and offshore private funds (which are likely not subject to the Private Funds Rules), especially when the US private funds are parallel or feeder funds with the offshore funds, will have to consider whether to extend the protections of the Private Funds Rules to

the offshore funds and their investors, even if they would not otherwise be required to do so. It should not come as a surprise if some offshore regulators and influential institutional investors insist on extending the protections of the Private Funds Rules to offshore funds and their investors under these circumstances, even if the private funds are not covered for purposes of US law.

Lastly, the application of new record-retention rules to prospective non-US investors in a private fund may conflict with the private fund’s obligations under the data protection and marketing rules of other jurisdictions, such as the EU’s General Data Protection Regulation (GDPR).

For offshore investment advisers, there are questions relating to the application of the Private Fund Rules, especially to offshore private funds. Perhaps the most significant variable, however, will be the reaction of

offshore regulators and influential offshore institutional investors to offshore fund terms that are materially different and less favourable from the corresponding terms of related US private funds. Even if the Private Funds Rules were not intended to apply to offshore investment advisers and their offshore funds, offshore investment advisers may likely have to confront the Private Funds Rules, nevertheless. ■

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