Davis Polk

Investment Management & Funds Regulatory Update - August 2025

August 29, 2025 | Client Update | 6-minute read

In this issue, we discuss an ADI issued by the SEC's Division of Investment Management regarding registered closed-end funds of private funds, as well as a recent enforcement action involving a private fund adviser's calculation of management fee offsets.

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Industry update

SEC's Division of Investment Management issues Accounting and Disclosure Information (ADI) regarding registered closed-end funds of private funds

In an ADI issued on August 15, 2025, the SEC staff stated that when reviewing registration statements for closed-end funds of private funds (CE?FOPFs), the staff will no longer request that registrants either (i) include accredited investor status and minimum investment requirements or (ii) limit their private fund investments to 15% of their assets. This ADI followed SEC Chairman Paul Atkins's remarks at the May 19, 2025 SEC Speaks in which he noted that the SEC would reconsider these historical requirements. The ADI highlighted that investors in CE-FOPFs have certain regulatory protections under federal securities laws that differ from the safeguards in place for direct investors in private funds, including requirements regarding disclosure, board governance, mandatory compliance programs, limits against excessive leverage, limits on overly complex capital structures and limits on conflicted transactions.

The ADI also provided guidance on the following topics for CE-FOPFs:

Disclosure

The staff noted that when reviewing CE-FOPF registration statements, the staff will continue to focus on disclosure to promote retail investors' understanding of CE-FOPFs and to assist them in making informed investment decisions. The ADI emphasized that a CE?FOPF's liquidity terms should be clearly and prominently disclosed, and that a CE-FOPF should "provide full disclosure of its costs, strategies, and risks, as well as the investment process-related due diligence practices conducted by the adviser when evaluating private fund investment opportunities (including investment, operational, legal, and, as applicable, tax considerations)." Regarding disclosure of fees and costs, the ADI noted that a CE?FOPF should explain the fee structures (including performance fees) of the underlying private funds and how the multiple layers of direct and indirect fees could affect the underlying private funds' returns and the CE-FOPF's performance. For example, the staff highlighted that CE-FOPFs should disclose "the effect of any underlying private fund performance fees or incentive allocations on the CE?FOPF's performance, including the possibility that certain of the underlying private funds may receive performance fees, even if other underlying private funds – or the overall performance of the CE?FOPF itself – is negative (i.e., 'netting risk')."

In the ADI, the staff encouraged CE-FOPFs to make sufficient disclosures regarding the underlying private funds, including, in the CE-FOPFs' strategy and risk disclosures, a full discussion of the risks and considerations relating to the private funds' investment strategies, risks associated with more volatile or speculative investments, conflicts of interest and the liquidity of the private funds' underlying investments. The ADI noted in particular that CE-FOPFs should disclose that:

- "the underlying private funds in which they invest (as compared to registered funds) are not limited by the 1940 Act in how they invest their assets (e.g., leverage and transactions with affiliates);" and
- "the underlying private funds' investments may impact the strategies, risks, and costs of and for the CE-FOPF itself. The CE-FOPF should disclose that shareholders may have limited information about the underlying private funds in which it is investing, including with respect to the underlying private funds' holdings, liquidity, and valuation."

Further, the staff noted in the ADI that, to the extent material, a CE-FOPF should consider disclosing: the legal jurisdictions of underlying private funds; the liquidity terms for the private fund investments (e.g., mandatory minimum holding periods, limitations or suspensions of redemptions and potential "payment in kind" distributions in response to redemption requests) and how such liquidity terms may impact the fees, performance and liquidity of the CE-FOPF; and tax considerations arising from investing in private funds that produce non-qualifying income that may have an impact on the CE-FOPF's pass-through status as a RIC.

Filings

Regarding filings, the ADI noted that:

- A CE-FOPF that invests 15% or more of its assets in private funds and has removed, or now seeks to remove, accredited investor and/or investment minimum shareholder limitations from its registration statement should: (i) file amendments to its registration statement through Rule 486(a)-(b); or (ii) file prospectus supplement updates through Rule 424, as appropriate. The ADI noted that CE-FOPFs should consider whether the cumulative changes in the amendments and updates are material, which would require SEC staff review under Rule 486(a).
- A CE-FOPF that invests less than 15% of its assets in private funds and never imposed the accredited investor and/or investment minimum shareholder limitations in its registration statement but now seeks to remove the 15% limitation should make such changes through a post-effective amendment to its registration statement under Rule 486(a). According to the ADI, such changes are material and should be reviewed by the SEC staff.

The ADI generally encouraged CE-FOPFs to engage with the staff to determine what filings and disclosures are appropriate.

Litigation

SEC charges private fund adviser with breach of fiduciary duty in its calculation of management fee offsets

On August 15, 2025, the SEC issued an order (the Order) instituting and settling administrative and cease-and-desist proceedings against a registered investment adviser (RIA) for alleged breaches of fiduciary duty in calculating management fee offsets for transaction fees it received from portfolio companies. According to the Order, the RIA's calculation of certain management fee offsets resulted in conflicts of interest that were not adequately disclosed to its private fund clients (the Funds) or the Funds' limited partners, and were inconsistent with the Funds' limited partnership agreements. Firstly, as described in the Order, the management services agreement between the RIA and the portfolio companies typically provided that payment of transaction fees would be deferred at the election of the RIA or if required by relevant loan covenants, and that the RIA could charge interest during the deferral period at an annual rate of 8%. According to the Order, at the time the RIA received deferred transaction fees, the RIA included such transaction fees in its calculation of management fee offsets, but did not include the interest payments it received, which resulted in the Funds receiving lower fee offsets than they would otherwise be entitled to receive. The Order noted that the RIA did not adequately disclose this practice or the resulting conflict of interest, and did not seek to mitigate the conflict by including the interest payments in the fee offsets for the Funds.

In addition, as described in the Order, the limited partnership agreements for the Funds provided that each Fund's management fee offset would be based on all transaction fees received by the RIA from a portfolio company, and that each Fund's allocation of such transaction fees would be reduced to account for other Funds' and co-investors' fully diluted equity ownership of the portfolio company. According to the Order, with respect to at least one portfolio company in which the Funds invested, the RIA allocated to each Fund a pro rata portion (as opposed to all) of the transaction fees it received based on such Fund's share of the total capital invested by the Funds, and then further reduced each Fund's allocation based on such Fund's fully diluted equity ownership of the portfolio company. The Order noted that such calculation was inconsistent with the Funds' limited partnership agreements and resulted in the Funds receiving lower fee offsets than they would otherwise be entitled to receive.

On account of this alleged conduct, the SEC charged the RIA with willful violations of Section 206(2) of the Advisers Act. The RIA agreed to cease and desist from future violations and to pay disgorgement of $502,041, prejudgment interest of $6,836 and a civil penalty of $175,000.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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