Articles
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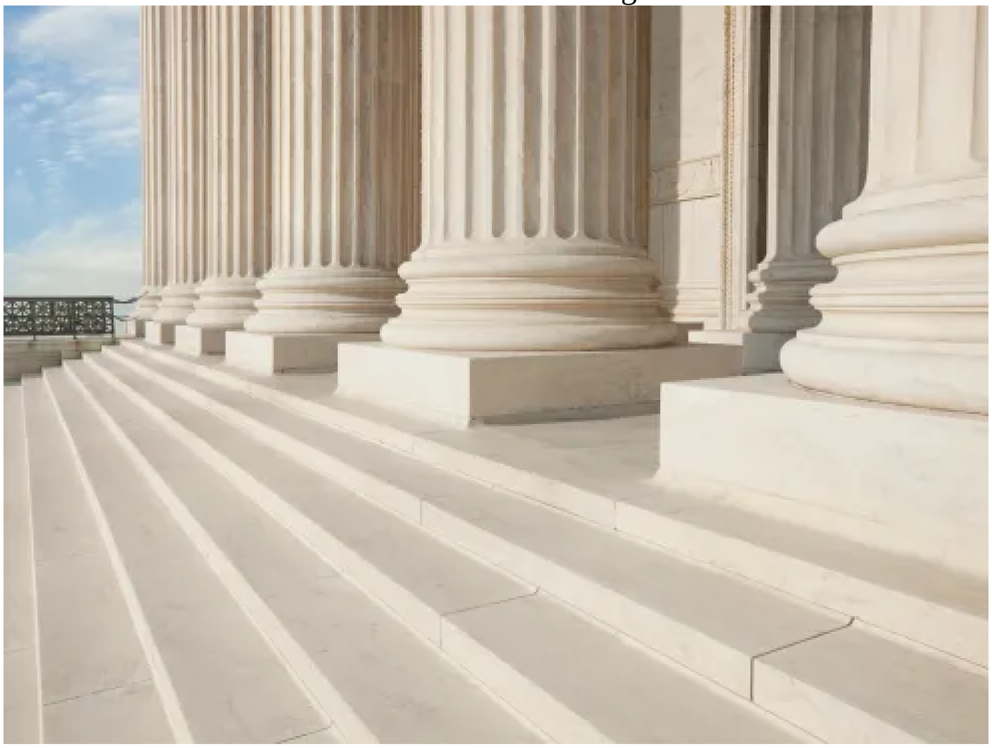
The New Private Fund Rules: What Now for Registered Advisers?



As reported in our recent blog post, "SEC Imposes New Burdens on Registered and Exempt Private Fund Advisers," the U.S. Securities and Exchange Commission (the SEC) has adopted significant new rules[1] under the Investment Advisers Act of 1940 (the Advisers Act) that apply to investment advisers to private funds[2] that are registered with the SEC.

Substantial undertakings will likely be required of private fund advisers to meet new the requirements around restricted activities, preferential treatment of investors, quarterly investor statements, fund audits and adviser-led secondary transactions.[3]

The SEC's new restricted activities and preferential treatment rules also apply to exempt reporting advisers (ERAs). Please see our **cheat sheet** (attached here as **Appendix A**) that answers basic questions about the new rules and their application to registered private fund advisers and ERAs.

Below, we delve into the new rules and offer steps that SEC-registered private fund advisers should take sooner rather than later to begin the compliance implementation process. All impacted advisers will be required to comply within 18 months of the final new rules publication in the *Federal Register*, with a 12-month compliance period for larger firms.[4]

**Quarterly Statements[5]**

New Rule 211(h)(1)-2 under the Advisers Act (the Quarterly Statement Rule), which will require registered advisers to distribute detailed quarterly statements to their private fund investors, aims "to facilitate the provision of simple and clear disclosures to investors regarding some of the most important and fundamental terms of their relationships with investment advisers to private funds." Fees and expenses remain a top examination and enforcement priority at the SEC, and the Adopting Release cites recent cases where "advisers have overcharged certain fees without investors recognizing it immediately." Conflicts of interests and fraud are also constant focus areas across the SEC, and the Quarterly Statement Rule is intended "to improve investors' ability to evaluate the adviser's conflicts of interest with respect to the fees and expenses charged to the fund by the adviser and the performance metrics that the adviser presents to investors."[6]

Quarterly investor statements must include prominent disclosures about how expenses, payments, allocations, rebates, waivers, and offsets are calculated. They must cross-reference the relevant sections of the fund's offering documents.

Developing systems to produce and deliver the quarterly reports will be a heavy lift for some firms, and the Quarterly Statement Rule is one of the most contentious aspects of the rulemaking package. Notably, the SEC adopted the Quarterly Statement Rule despite industry protests that it "would increase costs for private funds that would ultimately be passed on to investors" and that "the rule is unnecessary and duplicative, as advisory firms already provide similar or otherwise sufficient reporting, and investors are generally able to negotiate for and receive additional disclosure that may be appropriate for their particular needs."

Key features of the Quarterly Statement Rule—including disclosure details, delivery deadlines, and exemptions—and our suggested steps toward implementation, are as follows:

**Fund Fees and Expenses Table**

- *Compensation paid or allocated to the adviser* or its related persons,[8] such as management, advisory, sub-advisory fees, and performance-based compensation,[9] set forth in separate line items[10]
- *All other paid and allocated fund expenses,*[11] with separate line items for each category of fee or expense[12]
- *Offsets or rebates to adviser compensation*, including those carried forward to reduce future payments or allocations to the adviser or its related persons, with separate line items for the payments/allocations before and after the offset or rebate

**Fund Portfolio Table**

- Any "portfolio investment compensation"[13] allocated or paid by a "covered portfolio investment,"[14] set forth in separate line items for each category[15] and for the payments/allocations before and after the offset or rebate

**Disclosure Details for each Reporting Period:** [7]

**Calculations and Cross-References**

- Prominent disclosure regarding the calculation methodologies for expenses, payments, allocations, rebates, waivers, and offsets, with cross-references to the relevant sections of the fund's organizational and offering documents[16]

**Performance Disclosure**[17]

- *Liquid funds*[18]
  - Annual net total returns since inception or for each fiscal year over the past 10 years, whichever is shorter
  - Average annual net total returns over one-, five-, and 10-year periods
  - Cumulative net total return for the current fiscal year
  - Quarter covered by the quarterly statement
- *Illiquid funds*[19]
  - Internal rates of return (IRR)[20] and multiples of invested capital (MOIC)[21] since inception
  - Statement of contributions and distributions[22]
  - Criteria used and assumptions made in calculating performance
  - Consolidation of reporting to cover similar asset pools

**Delivery Deadline:**

- *Traditional private funds:* 45 days after first three fiscal quarters and 90 days after each fiscal year[23]
- *Private funds of funds:* 75 days after first three fiscal quarters and 120 days after each fiscal year

**Exemptions:**

- None, even for small and emerging advisers, and investors may not waive the requirement

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| **Steps Toward Implementation – Begin Now:** | • Start working with counsel now to develop an approach to meeting the Quarterly Statement Rule requirements. Depending on an adviser's investor base and existing reporting approach and infrastructure, this could be a relatively simple or extremely complicated project.<br>◦ Specific "distribution," format and content, and new recordkeeping requirements apply.<br>◦ Automation may be an attractive option.<br>◦ Identifying existing and/or new service providers to facilitate reporting may be key.<br>◦ It will be crucial to review existing investor reporting protocols, contracts (including fund offering documents), and policies and procedures for any necessary updates. |

**Mandatory Private Fund Audits[24]**

New Rule 206(4)-10 under the Advisers Act (the Mandatory Audit Rule) requires registered advisers to effect audits for their private funds "in accordance with the audit provision (and related requirements for delivery of audited financial statements)" under the Advisers Act custody rule (the Custody Rule) applicable to pooled investment vehicles subject to annual audit.[25] In other words, private fund advisers may no longer choose to rely on the surprise examination option under the Custody Rule.

Other key features of the Mandatory Audit Rule, along with our suggested steps toward implementation, are as follows:

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| **Details:** | • Independent public accountant must be registered with, and subject to regular inspection by, the PCAOB.[26]<br>Audits must be prepared in accordance with U.S. generally accepted auditing standards (GAAS); audited financials must be prepared in accordance with U.S. generally accepted accounting principles (GAAP).<br>• Specific new recordkeeping requirements apply. |
| **Delivery Deadline:** | • 120 days after the end of each fiscal year and promptly upon liquidation |
| **Exemptions:** | • None |

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| **Steps Toward Implementation – Begin Now:** | • The SEC reports that approximately 90% of hedge funds and private equity funds advised by SEC-registered advisers currently meet the mandatory private fund audit requirement.<br>• Advisers relying on the surprise examination provisions of the Custody Rule should check with their accounting firm soon to ensure they can assist the firm in meeting the requirements by the compliance deadline.<br>• Advisers should also work with counsel to review their existing auditor engagements and policies and procedures for any necessary updates, including for specific new recordkeeping requirements. |

**Adviser-Led Secondaries[27]**

New Rule 211(h)(2)-2 under the Advisers Act (the Secondaries Rule) requires registered advisers, when initiating a transaction that offers existing private fund investors "the option between selling all or a portion of their interests in the private fund and converting or exchanging them for new interests in another vehicle advised by the adviser or any of its related persons"[28] to obtain and distribute to investors (1) a fairness or valuation opinion and (2) a summary of any material business relationships between the adviser and the opinion provider that occurred within the previous two years. The SEC believes that "this rule will provide an important check against an adviser's conflicts of interest in structuring and leading such a transaction from which it may stand to profit at the expense of private fund investors." Moreover, the opinion requirement, the SEC asserts, is well-suited "to address the conflicts inherent within adviser-led secondary transactions because the presence of an independent third party reduces the possibility of fraudulent, deceptive, or manipulative activity."

Key features of the Secondaries Rule—including example transactions, and details on the requisite opinions and relationship summary—and our suggested steps toward implementation are as follows:

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| **Example Transactions:** | • One fund selling all or part of a portfolio holding to another fund managed by the adviser, "if investors have the option between obtaining liquidity and rolling all or a portion of their interests into the other vehicle"<br>• Strip sale transactions where a fund sells a portion of multiple assets to a new fund managed by the adviser<br>• Full fund restructurings, where a fund sells all of its assets to a new fund managed by the adviser |

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| **Opinions and Relationship Summary Details:** | • A *fairness opinion* must state in writing that the price being offered as part of an adviser-led secondary transaction is fair<br><br>*or*<br>• A *valuation opinion* must state in writing the value (as a single amount or a range) of any assets being sold<br>• *Summary of material business relationships* must be in writing and describe material relationship(s) that the adviser or any of its related persons has had with the independent opinion provider within the two-year period immediately prior to the issuance date of the fairness opinion or valuation opinion.[29] |
| **Delivery Deadline:** | • Ad hoc, prior to an investor electing to participate in the transaction (*i.e.*, prior to the due date of the election form)[30] for the transaction |
| **Exemptions:** | • None, even for market-driven discovery processes |
| **Steps Toward Implementation – Begin Now:** | • Start working with counsel now to develop an approach to the Secondaries Rule. Depending on an adviser's investment strategies, portfolio pipeline, investor base, and other factors, this could be a relatively simple or significant undertaking.<br>  ○ Identify and engage one or more parties to provide fairness and/or valuation opinions.<br>  ○ Specific new recordkeeping requirements apply.<br>  ○ It will be key to review existing secondary operations and protocols, contracts (including fund offering documents), and policies and procedures for any necessary updates. |

**Restricted Activities[31]**

***Five Potentially Harmful Practices*.** New Rule 211(h)(2)-1 under the Advisers Act (the Restricted Activities Rule), which applies to registered private fund advisers and ERAs, is intended to address five practices that the SEC believes are potentially harmful to investors because investors are not capable of judging the impact of the practices and even limited partner advisory committees (LPACs) are not always able to effectively oversee them. These restricted activities include:

1. Causing a private fund to pay fees and expenses associated with an investigation of the adviser without prior written consent.
2. Causing a private fund to pay for regulatory, examination, or compliance fees or expenses of the adviser without specific disclosures.
3. Reducing the amount of the adviser's carried interest clawback by the amount of the adviser's taxes without specific disclosures.
4. Allocating or charging fees or expenses related to portfolio investment shared among multiple private funds and/or related persons without advance written notice of the non-pro rata charge and a description of how the adviser believes it is fair and equitable.

5. Borrowing money or securities from a private fund without sufficient disclosure and written consent.

The SEC explains in the Adopting Release its view that disclosure/consent is necessary to allow these practices because they "involve conflicts of interest (e.g., borrowing directly from a private fund client may benefit the adviser while not being in the best interest of the fund) and compensation schemes (e.g., passing certain expenses on to funds, which increases the adviser's revenue and decreases the fund's profits) that are contrary to the public interest and the protection of investors" against "fraud and deception." The SEC notes that its "concerns with these activities have persisted despite . . . related enforcement actions."

***Disclosure/Consent: A Path to Permissibility.*** Looking closely, the restricted activities fall into two buckets: (1) those that are permissible only if an adviser "distributes"[32] disclosure *and* obtains written consent; and (2) those that only require the distribution of disclosure. The SEC's reasoning is that investors may "benefi[t] from these activities when they are carried out in the best interests of the fund, if . . . provided with disclosures and, in some cases, consent rights."

Where the Restricted Activities Rule requires written consent, advisers must try to obtain consent from all of a private fund's investors and must secure consent from at least a majority in interest of outside investors. Importantly, a private fund's LPAC, advisory board, board of directors or similar governing body cannot consent to these practices; rather, consent must be provided by the individual investors. With investors that are funds of funds or other pooled vehicles and in a "control relationship" with the adviser or any of its related persons, the adviser must work to distribute disclosure to and obtain consent from the underlying individual investors.[33]

And it gets more complicated. As set forth in the table and associated notes below, in certain cases, the disclosure must be made, and consent obtained, prior to the adviser engaging in the "restricted" activity, while in others, the adviser must provide "after-the-fact" disclosures. Certain limits apply, and certain disclosures must address specific points. A bevy of statutory definitions apply. And as discussed in greater detail below, "legacy status" treatment is available under certain circumstances.

| | **Advance Disclosure** | **Subsequent Disclosure [34]** | **Consent** | **Legacy Status Option** |
|---|---|---|---|---|
| 1. Adviser investigation expenses[35] | X | | X | X |
| 2. Adviser regulatory, examination, or compliance fees | | X[36] | | |
| 3. Adviser post-tax clawbacks[37] | | X[38] | | |
| 4. Non-pro rata allocations | X[39] | | | |
| 5. Borrowing from fund clients[40] | X | | X | X |

Under specific new recordkeeping requirements, advisers must document their compliance with the disclosure and consent requirements of the Restricted Activities Rule, including by maintaining records of the disclosure, consent and other documents distributed in accordance with the Restricted Activities Rule.

***Legacy Status: Grandfathering Certain Restricted Activities.*** The Restricted Activities Rule with respect to adviser investigation costs and borrowings does not apply to existing funds and their contractual agreements, except that "legacy status" is not available for fees or expenses related to an investigation that results in Advisers Act sanctions for the adviser. Where available, legacy status applies to agreements entered into prior to the compliance date of the Restricted Activities Rule by private funds that had commenced operations as of that date.[41]

***Steps Toward Implementation: Begin Now.*** Although the compliance date for the new rules is approximately a year and a half out, advisers should begin now working with counsel to assess the extent to which their operations, contracts and policies and procedures are implicated by the new rules.

- One phase of implementation will likely involve identifying and memorializing existing arrangements that can be grandfathered under the legacy status provisions of the new rules.
- Another phase will be determining whether to take advantage of any of the disclosure/consent exceptions and if so, preparing standard disclosure and consent forms and related procedures.
- Still another will entail reviewing protocols, contracts (including fund offering documents), and policies and procedures for any necessary updates.

**Preferential Treatment[42]**

***Strict Limits on Redemption and Information Rights***. New Rule 211(h)(2)-3 under the Advisers Act (the Preferential Treatment Rule), which applies to registered private fund adviser and ERAs, is intended to address SEC concerns about side letters and other arrangements that benefit some investors at the expense of others. Advisers, the SEC also worries, have incentives to provide more favorable rights to larger investors and those that offer financial or other benefits to the adviser. The Preferential Treatment Rule prohibits an adviser from, directly or indirectly, granting:

- *Favorable redemption or liquidity rights* to an investor in a private fund or in a "substantially similar pool of assets"[43] if the adviser "reasonably expects"[44] the preferential rights to have a "material, negative effect"[45] on other investors in the fund or substantially similar pool of assets, *unless* (1) the redemption rights are required by the applicable laws, rules, regulations or orders of any relevant government[46] or (2) the adviser offers the same redemption rights to *all* existing and future investors in the private fund or similar pool of assets *without qualification*[47] as to commitment size, affiliation or other factors.
- *Favorable portfolio holdings and exposure information rights* to an investor in a private fund or a substantially similar pool of assets if the adviser reasonably expects the information would have a material, negative effect on other investors in the fund or substantially similar pool of assets, *unless* the adviser offers, at the same time or substantially the same time, the same information to all existing investors in the private fund or similar pool of assets and will continue to do so with future investors.

The above prohibitions apply to direct and indirect preferential rights and even if a related person of the private fund or the adviser grants the rights, not the adviser or fund itself. They are intended to be broad in scope and designed to prevent advisers from structuring around them.

The SEC emphasizes in the Adopting Release that "selective disclosure to certain parties is a fundamental concern often prohibited or restricted under other Federal securities laws" and that the Preferential Treatment Rule is designed to mitigate attempts by advisers to treat portfolio holdings information as a "commodity" that can be used to gain or maintain favors with certain investors. Specifically, the SEC is concerned about scenarios in which investors with preferential information rights are able to front run other investors noting that "the ability to redeem is an important part of determining whether providing information would have material, negative effect on other investors." Of course, the risk of preferential redemption (a material, negative effect on other investors) is not generally present in illiquid/closed-end private funds, like venture capital funds, where redemptions in the ordinary course are not allowed. The SEC acknowledges this, but insists that based on the facts and circumstances, including the adviser's reasonable expectations in providing any preferential redemption rights to an illiquid fund's investors, a material, negative impact on other investors could be found.

Under specific new recordkeeping requirements, advisers must document their compliance with the offer exceptions for preferential redemption and information rights described above, including by maintaining records of each such communication.

***Legacy Status: Grandfathering Redemption and Information Rights.*** The Preferential Treatment Rule with respect to redemption and information rights does not apply to agreements entered into prior to the compliance date of the Preferential Treatment Rule by private funds that had commenced operations as of that date.

***Transparency on Preferential Treatment.*** The Preferential Treatment Rule establishes that private fund advisers may not, directly or indirectly, provide any preferential treatment to any private fund investor unless the adviser provides certain disclosures, as described below.

The SEC believes that increased transparency in this regard "will better inform investors about the breadth of preferential treatment, the potential for those terms to affect their investment in the private fund, and the potential costs (including compliance costs) associated with these preferential terms . . . help investors understand whether, and how, such terms present conflicts of interest or otherwise impact the adviser's compensation schemes with the private fund . . . [and] also help prevent investors from being potentially defrauded or deceived by preferential treatment that negatively impacts their investment in the private fund." The SEC also expects this sunlight to aid investors in learning "whether other investors are receiving a better or different deal and whether any such arrangements pose potential conflicts of interest, potential harms, or other disadvantages (e.g., to the extent other investors are excused from participating in certain types of investments, such as alcohol-related investments, the participating investors may become over concentrated in such investments)."

- The Preferential Treatment Rule requires that written disclosure be distributed to prospective private fund investors, in advance of their investment, regarding *any preferential treatment related to any material economic terms* that the adviser and/or its related persons provide to other investors in the same fund. Material economic terms must be described in detail and include, but are not limited to, those related to the cost of investing, liquidity rights, fee breaks, and co-investment rights.
- The Preferential Treatment Rule requires that written disclosure be distributed regarding *all other preferential terms* that the adviser and/or its related persons provide to other investors in the same fund:
- To current investors in an illiquid fund as soon as reasonably practicable after the end of the fundraising period and to current investors in a liquid fund as soon as reasonably practicable following their initial and any subsequent investment in the fund.
- To all private fund investors, and any underlying fund of fund investors, at least annually.[48]

All of these disclosures must be made with specificity. While the exact fees or other contractual terms need not necessarily be disclosed, "mere disclosure," for example, "of the fact that other investors are paying lower fees" is not sufficient . . .an adviser must describe the lower fee terms, including the applicable rate (or range of rates if multiple investors pay such lower fees), in order to provide specific information as required by the rule."

***Steps Toward Implementation: Begin Now.*** As with the Restricted Activities Rule, advisers should begin collaborating with counsel now to assess the extent to which the Preferential Treatment Rule will affect their operations, contracts and policies and procedures. Tasks will likely include:

- Identifying and memorializing existing redemption and information rights that can be grandfathered under the legacy status provisions;
- Determining whether to take advantage of any of the offer-based exceptions that allow preferential treatment and if so, preparing standard offer and disclosure templates; and

- Reviewing protocols, contracts (including fund offering documents), and policies and procedures for any necessary updates.

**Conclusion**

The SEC's new rules for private fund advisers are multi-faceted and stand to disrupt the way some firms do business. Like the rule proposal that would have plumbed even farther into the depths of private fund firm operations, the new rules have not been well received. Indeed, their ultimate fate remains in the balance as well-known industry groups have sued the SEC over the new rules. That, and any similar litigation, is unlikely to resolve, however, before the compliance date for the new rules, which is approximately a year away on some requirements for larger firms. As noted above, we suggest that firms go ahead and begin the journey to full compliance with the new rules now. Our team is available to assist.

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**APPENDIX A: Quick Answers on the SEC's New Private Fund Adviser Rules**

| | WHO does this apply to? | WHAT does it require? | WHEN is the deadline? | WHERE is there a way out? | WHY is the SEC doing this? |
|---|---|---|---|---|---|
| **Quarterly Statement Rule** | RIAs | Quarterly investor statements detailing fund fees, expenses and performance | 18 months from publication of final rules | None | Concerns with conflicts and fraud, misleading/insufficient disclosure |
| **Mandatory Audit Rule** | RIAs | Obtain an independent audit and distribute audited financial statements consistent with the custody rule (nothing new for most firms) | 18 months from publication of final rules | None | Concerns with conflicts and fraud, misappropriation of assets and valuation accuracy |

| | WHO does this apply to? | WHAT does it require? | WHEN isthe deadline? | WHERE is there a wayout? | WHY is the SEC doing this? |
|---|---|---|---|---|---|
| **Adviser-Led Secondaries Rule** | RIAs | Distribute an independent fairness opinion or valuation opinion and disclose material business relationships with opinion provider | 12 or 18 months from publication of final rules * | None | Concerns with conflicts and fraud, investor manipulation |
| **Restricted Activities Rule** | RIAs and ERAs | Restriction on the following to a private fund without appropriate disclosure along specified timelines:<br>• Charging adviser investigation expenses or adviser regulatory, examination or compliance fees<br>• Post-tax clawbacks<br>• Non-pro rata allocations<br>• Borrowing from the fund | 12 or 18 months from publication of final rules* | Disclosure and consent-based exemptions<br><br>Legacy treatment for operating funds with agreements made prior to the compliance date # | Concerns with conflicts and fraud, misleading/insufficient disclosure |

| | WHO does this apply to? | WHAT does it require? | WHEN isthe deadline? | WHERE is there a wayout? | WHY is the SEC doing this? |
|---|---|---|---|---|---|
| **Preferential Treatment Rule** | RIAs and ERAs | Prohibition on providing the following to a private fund investor without appropriate offers and disclosure along specified timelines:<br>• Preferential redemption and information rights, if a potential material, negative effect on other investors<br>• Preferential treatment related to material economic terms<br>• Annual transparency report | 12 or 18 months from publication of final rules* | Offer and disclosure-based exemptions<br><br>Legacy treatment for operating funds with agreements made prior to the compliance date | Concerns with conflicts and fraud, material negative effects on other investors and adviser incentives |

**Endnotes**

[1] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance*, SEC Rel. No. IA-6383 (Aug. 23, 2023) (Adopting Release). It is outside the scope of this article, but with the Adopting Release the SEC also adopted rule amendments under the Advisers Act requiring written documentation of all SEC-registered advisers' annual compliance program reviews, with a short 60-day compliance deadline.

[2] Under the Advisers Act, a "private fund" is any issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for Sections 3(c)(1) or 3(c)(7) thereof.

[3] Typically, an ERA is exempt from registration under either Section 203(l) of the Advisers Act (venture capital fund advisers) or Section 203(m) of the Advisers Act (private fund advisers with less than $150 million in assets under management).

[4] The compliance period for the Quarterly Statement Rule and the Mandatory Audit Rule (each defined above) is 18 months and the compliance period for the Secondaries Rule, the Restricted Activities Rule and the Preferential Treatment Rule is 12 months for larger advisers (? $1.5 billion in private fund assets) and 18 months for smaller advisers (< $1.5 billion in private fund assets).

[5] *See generally* Adopting Release at Section II.B.

[6] As examples from recent enforcement cases, among others, the SEC suggests that advisers might be fraudulently deceptive and in breach of their fiduciary duties in "charging investors a management fee and simultaneously charging a portfolio company a monitoring or similar fee without disclosing that fee to investors," or "knowingly using off-market assumptions (such as highly irregular valuation practices that are not used by similarly-situated advisers) when calculating performance without disclosing such to investors."

[7] Information is to be provided at the fund level; class level reporting is not required.

[8] An adviser's "related persons" include: (1) all officers, partners, or directors (or any person performing similar functions); (2) all persons directly or indirectly controlling or controlled by the adviser; (3) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser. *See* the definition of "control" at n. 33 *infra*.

[9] These include, for the avoidance of doubt, "allocations, payments, or distributions of capital based on a private fund's (or its investments') capital gains, capital appreciation, and/or profit."

[10] The "exclusion of *de minimis* expenses, the general grouping of smaller expenses into broad categories, [and] the labeling of expenses as miscellaneous" is not permitted.

[11] Such as, but not limited to, fund "organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses."

[12] Still, fund expenses may not be grouped "into broad categories that obfuscate the nature and/or extent of the fees and expenses borne by the fund."

[13] "Any compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons by the portfolio investment attributable to the private fund's interest in such portfolio investment."

[14] These are fund portfolio investment holdings "that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period." More specifically, the term "portfolio investment" is defined as any entity or issuer in which a private fund, directly or indirectly, has invested or holds an investment during the reporting period.

[15] These include, but are not limited to, "origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments by the covered portfolio investment to the investment adviser or any of its related persons." The SEC states that "a fund of funds adviser may have to rely on good faith belief to determine which entity or entities constitute a portfolio investment under the rule."

[16] This, the SEC explains, will "generally require advisers to describe, among other things, the structure of, and the method used to determine, any performance-based compensation set forth in the quarterly statement (such as the distribution waterfall, if applicable) and the criteria on which each type of compensation is based ( *e.g.*, whether such compensation is fixed, based on performance over a certain period, or based on the value of the fund's assets)."

[17] Importantly, the SEC indicates that this information would not be considered an advertisement within the meaning of the Advisers Act marketing rules unless used to offer new or additional advisory services with respect to securities referenced in the quarterly statement. The SEC believes that "more standardized requirements for performance metrics will allow private fund investors to compare more easily the returns of similar fund strategies over different market environments and over time." Further, the SEC worries that some

"adviser approaches to performance reporting may be misleading without the benefit of adequately disclosed assumptions."

[18] Private funds that fall into the "liquid fund" definition generally allow periodic investor redemptions, such as monthly, quarterly, or semi-annually. The SEC acknowledges the similarity of these reporting requirements to those applicable to mutual funds and other registered funds.

[19] "Illiquid fund" is defined as a private fund that: (1) is not required to redeem interests upon an investor's request and (2) has limited opportunities, if any, for investors to withdraw before termination of the fund.

[20] "Internal rate of return" or "IRR" means the discount rate that causes the net present value of all cash flows throughout the life of the fund to be equal to zero.

[21] "Multiple of invested capital" or "MOIC" means, as of the end of the applicable fiscal quarter, the sum of the unrealized value of the illiquid fund and the value of all distributions made by the illiquid fund, divided by the total capital contributed to the illiquid fund by its investors.

[22] Specifically, it must include, with separate line items with and without the impact of any fund-level subscription facilities, gross and net IRR and MOIC for the illiquid fund and for the realized and unrealized portions of its portfolio, with separate line items for the realized and unrealized performance.

[23] There is a grace period for new private funds, with the first quarterly statement due 45 days after first two full fiscal quarters of operating results.

[24] *See generally* Adopting Release at Section II.C.

[25] *See* Rule 206(4)-2(b)(4)(i)-(iii) under the Advisers Act.

[26] Public Company Accounting Oversight Board.

[27] *See generally* Adopting Release at Section II.D.

[28] If the adviser, at the unsolicited request of an investor, assists in the secondary sale of the investor's fund interest, the transaction would not be considered an adviser-led secondary transaction. Similarly, routine rebalancing between parallel funds and season and sell transactions between parallel funds would not be considered adviser-led secondary transactions.

[29] Audit, consulting, capital raising, investment banking, and other similar service/client relationships would be considered material relationships impinging on independence.

[30] "Election form" means a written solicitation distributed by, or on behalf of, the adviser or any related person requesting private fund investors to make a binding election to participate in an adviser-led secondary transaction (e.g., a subscription booklet).

[31] *See generally* Adopting Release at Section II.E.

[32] An adviser generally will satisfy the requirement to "distribute" disclosure when it sends the disclosure to all investors in a fund, including the underlying investors of any investor that is itself a fund or other pooled vehicle. Distribution can be achieved, and written consent can be obtained, electronically in keeping with existing SEC guidance.

[33] An entity is in a control relationship with an adviser or its related person if it is controlling, controlled by or under common control with the adviser or its related person. New Rule 211(h)(1)-1 under the Advisers Act defines control for these purposes as the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. In addition, under the new rule: (1) an adviser's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) are presumed to control the adviser; (2) a person is presumed to control (a) a corporation, if the person has the right to vote 25% or more of a class of the voting securities or power to sell 25% or more of a class of the voting securities, (b) a partnership if the person has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the partnership and (c) a limited liability company (LLC) if the person has the right to vote 25% or more of a class of the LLC interests or the right to receive upon dissolution, or has contributed, 25% or more of the capital of the LLC, or is an elected manager of the LLC; and (3) a person is presumed to control a trust if the person is a trustee or managing agent of the trust. [27]

[34] The disclosure must be distributed within 45 days after the end of the fiscal quarter in which the relevant activity occurs which reflects the number of days the first three quarterly statements must be delivered to investors.

[35] Costs related to an investigation of the adviser that results in Advisers Act sanctions may not be allocated to a private fund even with disclosure and consent, including where the adviser consented to an SEC order without admitting or denying the SEC's findings.

[36] The disclosure must include the dollar amount of the fees and expenses charged to the private fund.

[37] A "clawback" is "any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements."

[38] The disclosure must include the dollar amount of the adviser clawback before and after reduction for actual, potential, or hypothetical taxes.

[39] The disclosure must explain why the non-pro rata allocation is fair and reasonable and must "allow an investor to understand better how the adviser is treating the private fund relative to other private funds or clients advised by the adviser." The disclosure should address any conflicts of interest (such as additional compensation payable to the adviser) and risks of potential harms or other disadvantages for investors created by the non-pro rata allocation. It should also address the factors considered by the adviser in making the non-pro rata allocation and its determination of fairness and reasonableness. The SEC explains that whether an allocation or charge is fair and equitable depends on the facts and circumstances, including "factors relevant to the specific expense," for example, whether the charges relate "to a specific type of security that [only] one private fund client holds" or "a bespoke structuring arrangement for one private fund client to participate [that] does not benefit other clients" or a situation in which one private fund will benefit from the expense relative to other funds, "such as the potential benefit of certain insurance policies."

[40] Note that the SEC does not interpret ordinary tax advances or management fee offsets as borrowings for the purposes of this restricted activity.

[41] A fund will be considered to have commenced operations where there is "any bona fide activity directed towards operating a private fund, including investment, fundraising, or operational activity," such as "issuing capital calls, setting up a subscription facility for the fund, holding an initial fund closing and conducting due diligence on potential fund investments, or making an investment on behalf of the fund."

[42] *See generally* Adopting Release at Section II.G.

[43] This is defined as any pooled investment vehicle, other than an investment company registered under the Investment Company Act of 1940 or a securitized asset fund, that has substantially similar investment policies, objectives or strategies to those of the private fund, which requires a facts and circumstances analysis. The types of vehicles that would fall under qualifying "pool" is broad, not restricted to just private funds and is structure and entity agnostic. The SEC notes that while a pool with a materially a different target return or industry focus from a private fund would likely not share substantially similar investment policies, objectives, or strategies, it could be possible, for example, for a healthcare-focused private fund to be considered a similar pool of assets to the adviser's technology-focused private fund.

[44] This is intended to be an objective measure based on the facts and circumstances at the time the adviser grants or provides the preferential treatment and the adviser is not required to predict how others will react to it. "This standard is designed to facilitate the effective operation of the rule and to help ensure that preferential treatment granted to one investor does not have deleterious effects on other investors."

[45] The SEC has not provided a definition for the term "material, negative effect," so as to keep the rule "evergreen."

[46] The SEC provides as an example a "pension plan subject to State or local law . . . required to redeem its interest under certain circumstances, such as a violation by the adviser of State pay-to-play, anti-boycott, or similar laws." Any such preferential treatment must be disclosed pursuant to new Rule 211(h)(2)-3(b).

[47] In other words, there can be no exclusions, whether applied directly or indirectly, based on investor status, affiliation, or commitment size. As an example of a direct qualification, the SEC imagines "an adviser offering a fund with three share classes, each with different liquidity options but that are otherwise subject to the same terms" and restricting the more favorable classes to certain investor groups. Indirect qualifications are also prohibited and discussed in the Adopting Release.

[48] The SEC envisions this requirement driving "advisers to reassess periodically the preferential terms they provide to investors in the same fund, and investors will benefit from receiving periodic updates on preferential terms provided to other investors in the same fund (e.g., investors will benefit because they will be able to assess whether such preferential treatment presents new conflicts for the adviser)."

* 12 months for firms with ? $1.5 billion in private fund assets; 18 months for firms with < $1.5 billion.

# Not available for fees or expenses related to an investigation that results in Advisers Act sanctions for the adviser.



## Authors

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