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SEC adopts new rules and amendments that increase private fund adviser regulation

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The SEC's amendments include new requirements related to quarterly statements, private fund audits, adviser-led secondaries, restricted activities, preferential treatment and annual reviews under Rule 206(4)-7.

Summary

In an August 23, 2023 release (the adopting release), the Securities and Exchange Commission (SEC) voted to adopt long-awaited new rules and amendments under the Investment Advisers Act of 1940 (the Advisers Act) (the Rule). The Rule's effective date is November 13, 2023, with varying compliance dates described below:

- The compliance date for the amendment to the compliance rule under the Advisers Act (as discussed under "Key takeaways" below) is November 13, 2023.
- For the requirements regarding adviser-led secondary transactions, restricted activities and preferential treatment (as discussed under "Adviser-led secondaries," "Restricted activities" and "Preferential treatment/side letters," respectively, below), the compliance dates are: (a) for advisers with $1.5 billion or more in private fund assets under management, September 14, 2024 and (b) for advisers with less than $1.5 billion in private fund assets under management, March 14, 2025.
- The compliance date for the quarterly statement and private fund audit requirements (as discussed under "Quarterly statements" and "Mandatory private fund audits," respectively, below) is March 14, 2025.

The SEC noted that the Rule is designed in part to increase investors' visibility into certain adviser practices, but also to address adviser practices that can potentially lead to investor harm. As adopted, the Rule significantly increases regulatory compliance obligations of private fund advisers.

For example, the Rule prohibits private fund advisers, including unregistered advisers, from providing preferential redemption terms or certain information about portfolio holdings or exposures to any private fund investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a similar pool of assets, in each case, subject to certain exceptions.

The Rule also restricts (rather than strictly prohibits, as originally proposed) private fund advisers, including unregistered advisers, from engaging in certain activities and practices, unless they satisfy specific disclosure and, in some cases, consent requirements. These practices include (i) charging or allocating certain fees or expenses on a non-pro rata basis, (ii) reducing the amount of any adviser clawback by the amount of certain taxes, (iii) charging certain regulatory, compliance, examination and investigation fees and expenses of the adviser or its related persons and (iv) borrowing fund assets or receiving an extension of credit from private fund clients.

According to the adopting release, the SEC believes that these activities and practices involve conflicts of interest and compensation schemes that are "contrary to the public interest and the protection of investors." However, the SEC believes that the protective restrictions as adopted are reasonably designed to prevent fraud and deception.

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In addition to amending the books and records and compliance rules under the Advisers Act, the Rule also requires registered private fund advisers to:

- Provide investors with quarterly statements to increase transparency regarding the full cost of investing in private funds and the performance of such funds;
- Obtain a financial statement audit by an independent public accountant for each private fund at least annually and upon liquidation, and distribute such audited financial statements to investors; and
- Obtain and distribute to investors either a fairness opinion or a valuation opinion from an independent opinion provider in connection with certain adviser-led secondary transactions where such adviser offers fund investors the option to (x) sell their interests in the private fund or (y) exchange them for new interests in another vehicle advised by the adviser.

Key takeaways

The new rules and amendments contained in the adopting release are discussed in greater detail below. Some key takeaways of the Rule include:

- Rules requiring ***registered private fund advisers*** to (i) obtain and distribute to investors annual, audited financial statements prepared by independent public accountants, (ii) obtain and disclose to investors a fairness opinion or a valuation opinion from an independent opinion provider in connection with certain adviser-led secondary transactions and (iii) provide investors with quarterly statements that disclose detail on fund fees, expenses, and performance.
- Rules restricting ***all advisers of private funds (including unregistered advisers)*** from (i) charging or allocating certain fees or expenses on a non-pro rata basis, (ii) reducing the amount of any adviser clawback by the amount of certain taxes, (iii) charging certain regulatory, compliance, examination and investigation fees and expenses and (iv) borrowing fund assets or receiving an extension of credit from private fund clients.
- Rules prohibiting ***all advisers of private funds*** from providing certain preferential redemption and information rights.
- An amendment of the books and records rule under the Advisers Act, requiring advisers to retain records related to the Rule.
- An amendment of the compliance rule under the Advisers Act such that all ***registered investment advisers*** would be required to document their annual review in *writing*. The SEC did not prescribe any elements regarding what must be a part of the written review and intends for advisers to have flexibility with respect to how they satisfy this requirement.

Background

The adopting release describes the increasing importance of private funds and their advisers to investors, noting that there are now 5,248 registered private fund advisers holding over $26 trillion in private fund assets under management. The adopting release outlines the SEC's view that there are three primary factors that contribute to investor protection risks and harms: lack of transparency, conflicts of interest and lack of effective governance mechanisms for client disclosure, consent and oversight. It adds that the SEC has pursued enforcement actions against advisers for fraudulent practices related to fee and expense charges or allocations that are influenced by the advisers' conflicts of interest. According to the adopting release, despite the SEC's examination and enforcement efforts, problematic practices persist, necessitating new rules to protect investors, promote efficient capital markets and encourage capital formation.

Rules and amendments under the Advisers Act

Quarterly statements

The Rule requires an investment adviser that is registered or required to be registered to prepare and distribute quarterly statements which include certain information regarding fees, expenses and performance, on a consolidated basis for substantially similar pools of assets, for any private fund that it advises.[1] The SEC states in its adopting release that the Rule "is designed 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." The Rule was adopted substantially as proposed with certain modifications as noted below.

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Frequency: Quarterly statements must be distributed within 45 days after the end of each of the first three fiscal quarters of each fiscal year and 90 days after the end of each fiscal year (for fund-of-funds, within 75 days after the end of each of the first three fiscal quarters of each fiscal year of the private fund and 120 days after the end of the fiscal year of the private fund). If the private fund is newly formed, the initial quarterly statement is required to be issued after its first two full fiscal quarters of operating results.

Fees and Expenses: Advisers will need to disclose the following information in a table format:

– A detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the private fund during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount (e.g., management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation).
  - The Rule defines "related persons" as including: (i) all officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) 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. This definition is designed to capture the multiple affiliated but separate legal entities through which many advisers provide advisory services to, and receive compensation from, private fund clients.
  - The Rule defines "control" as the power, directly or indirectly, to direct the management of policies of a person, whether through ownership of securities, by contract, or otherwise.[2]
  - The SEC noted that the foregoing definitions are consistent with the definitions of "related person" and "control" used on Form ADV and Form PF, which advisers already have experience assessing as part of their disclosure obligations on those forms, and which capture the entities and personnel that advisers typically use to conduct a single advisory business and provide advisory services to a private fund.
  - The Rule defines "performance-based compensation" as allocations, payments, or distributions of capital based on a private fund's (or its investments') capital gains, capital appreciation, and/or profit. The SEC stated in its adopting release that the addition of "profit" (which was not in the proposed Rule) captures performance-based compensation that may be calculated based on other types or measures of investment performance, such as investment income.
  - Finally, the Rule clarifies that it does not require sub-advisory fees allocated or paid to a related person solely by the fund's adviser (and not by the fund) to be disclosed as a separate item of adviser compensation.

– A detailed accounting of all fund fees and expenses allocated to or paid by the private fund during the reporting period, other than those disclosed as adviser compensation, with separate line items for each category of fee or expense reflecting the total dollar amount (e.g., organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses).
  - For example, if a private fund paid insurance premiums, administrator expenses and audit fees during the reporting period, a general reference to "fund expenses" on the quarterly statement would not be sufficient. An adviser is required to list each specific category of expenses as a separate line item (e.g., insurance premiums, administrative expenses and audit fees) and the corresponding dollar amount.
  - If a fund expense could also be characterized as adviser compensation under the Rule, the Rule requires advisers to disclose such payment or allocation as adviser compensation and not as a fund expense in the quarterly statement.
  - Notably, in a change from the proposed Rule, the Rule as adopted captures not only amounts "paid by" the private fund but also fees and expenses "allocated to" the private fund during the reporting period. The SEC stated in the adopting release it believes this clarification is necessary to avoid potentially misleading investors in light of the various ways that a private fund may be caused to bear fees and expenses.

– The dollar amount of each category of adviser compensation or fund expense before and after the application of offsets, rebates and waivers for the reporting period. The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons.
  - As an example, to the extent that the fund's governing agreement requires the adviser to offset its management fee by any other fees received, the adviser is required to list the management fee both before and after the application of the fee offset.
  - The SEC clarified in the adopting release that offsets, rebates, and waivers applicable to certain, but not all, investors through one or more separate arrangements are required to be reflected and described prominently in the

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fund-wide numbers presented in the quarterly statement. In addition, advisers are not required to disclose the identity of the subset of investors that receive such offsets, rebates, or waivers.

Portfolio Investment-Level Disclosure: Advisers will need to disclose the following information in a table format:

– A detailed accounting of all portfolio investment compensation (including both cash and non-cash compensation) allocated or paid by each "covered portfolio investment" during the reporting period, with separate line items for each category of allocation of payment reflecting the total dollar amount, including 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 Rule defines "portfolio investment" as any entity or issuer in which the private fund has invested directly or indirectly, which would capture any entity or issuer in which the private fund holds an investment (e.g., through holding companies, subsidiaries, acquisition vehicles and special purpose vehicles). For example, if a private fund invests directly in a holding company that owns two subsidiaries, this definition captures all three entities. The adopting release clarifies that while certain investment strategies involve counterparties to negotiated instruments and contracts, such as derivatives, the SEC would generally not consider the fund to have made an investment in the counterparty in this context. In addition, to the extent the identity of any covered portfolio investment is not necessary for an investor to understand the nature of the conflict, advisers may use consistent code names (e.g., "portfolio investment A").
  - Advisers are only required to disclose information regarding "covered portfolio investments," which the adopting release defines as "portfolio investments that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period."
  - Portfolio investment compensation should not reflect the portion attributable to any other person's interest (e.g., co-investors) in the covered portfolio investment.
  - An adviser is required to list the amount of portfolio compensation before and after the application of offsets, rebates and waivers for the reporting period.
  - The adopting release clarified that this requirement does not include distributions representing profit or return of capital to the fund, in each case, in respect of the fund's ownership or other interest in a portfolio investment (e.g., dividends), and is intended generally to capture potentially or actually conflicted compensation arrangements where the fund's interest in a portfolio investment may be negatively impacted by that portfolio investment's allocation or payment of portfolio investment compensation to the fund's adviser or its related persons, such as when an adviser or its related person charges a monitoring fee to a portfolio investment of a fund it advises.

– Notably, the Rule deleted the proposed Rule's requirement to disclose a private fund's ownership percentage of each such "covered portfolio investment" as of the end of the reporting period.

Calculations and Cross References to Organizational and Offering Documents: Advisers are required to provide prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated, as well as cross-references to the relevant sections of the private fund's organizational and offering documents that set forth the calculation methodology.

Performance Disclosure: Advisers will need to include standardized performance in each quarterly statement provided to fund investors. The adviser will need to display the different categories of required performance information with equal prominence and include within the quarterly statement prominent disclosures of the criteria used and assumptions made in calculating the fund's performance; the requirements are generally consistent with the proposed Rule. For example, the SEC states in the adopting release that the Rule requires an adviser to an illiquid fund (as defined below) to show gross internal rate of return with the same prominence as net internal rate of return. Similarly, the Rule requires an adviser to a liquid fund to show the annual net total return for each fiscal year with the same prominence as the cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.

– *Key Clarifying Guidance*:

  - The SEC clarified in the adopting release that an adviser is free to include additional performance metrics in quarterly reporting, including those specifically negotiated by investors, beyond what is required by the new Rule. However, advisers should keep in mind that information in the quarterly statements could also be subject to Rule 206(4)-1 (the Marketing Rule) under the Advisers Act in certain contexts (e.g., an adviser offers new investment advisory services with regard to securities in the quarterly statement).

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    - The SEC further indicated in the adopting release that it declined to align the performance reporting standards in the Rule with the principles-based approach of the Marketing Rule, on the basis that the Rule is designed to meet the needs of current investors evaluating their portfolios while the Marketing Rule is primarily focused on prospective investors. As a result, advisers will need to apply different policies and procedures to performance disclosure depending on the format and intended audience.
    - The SEC stated in the adopting release that the adviser's (and its affiliates') interests in a private fund should generally be excluded when calculating performance for the quarterly statements to prevent the performance from being misleading. Because the interests are typically non-fee paying, the performance of the interests would serve to increase net returns in a way that could be misleading.
    - This reasoning suggests that other categories of non-fee paying investors (such as "friends and family") should also be excluded, although the SEC does not explicitly indicate as much. The SEC also does not specify how to treat adviser affiliates that invest on a reduced-fee, rather than no-fee, basis.
    - All private funds are being required to provide quarterly statements containing the performance metrics after the first two full fiscal quarters of operating results, notwithstanding that certain illiquid funds may have limited investment activities during their initial months.
    - The SEC stated in the adopting release that to the extent quarter-end numbers are not available at the time of the quarterly statement, an adviser is required to include performance measures through "the most recent practicable date," which would generally be the end of the immediately preceding quarter.
    - In the adopting release, the SEC stated that for purposes of the illiquid fund performance metrics, advisers generally should treat any distributions recalled by way of "recycling" provisions as additional contributions.
    - The SEC also stated that an adviser's methodology for determining whether an investment has been realized for purposes of the Rule must be properly documented, consistently applied and fully disclosed to investors.
    - In the adopting release, the SEC stated that the adviser must include relevant calculation assumptions as part of the quarterly statement itself. For instance, an illiquid fund adviser would disclose whether it assumed that dividends were reinvested, and a liquid fund adviser would disclose the use of assumed fee rates.
    - The SEC indicated that advisers should make supporting calculations to investors upon request, but such calculations need not be in the quarterly statement itself.

- *Illiquid and Liquid Funds*: The SEC has adopted a different approach for liquid and illiquid funds —

Illiquid funds

- An adviser to an illiquid fund will need to show performance based on (i) the gross internal rate of return and gross multiple of invested capital for the illiquid fund, (ii) net internal rate of return and net multiple of invested capital for the illiquid fund and (iii) gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions (shown separately) of the illiquid fund's portfolio, in each case, since such illiquid fund's inception and computed both with and without the impact of any fund-level subscription facilities (as defined below). The SEC largely adopted the requirements as proposed, other than with respect to reporting impact of fund-level subscription facilities. The Rule only requires an adviser to disclose gross performance metrics for the realized and unrealized portions of the illiquid fund's portfolio. The SEC stated in the adopting release that calculating net figures "could involve complex and potentially subjective assumptions regarding the allocation of fund-level fees, expenses and adviser compensation between the realized and unrealized portions," which assumptions could outweigh the benefits of disclosing net performance. By contrast, the Marketing Rule requires presentation of net performance information whenever gross performance is presented, which would seem to include the presentation of gross performance metrics for realized and unrealized portions of an illiquid fund's portfolio.
- The Rule defines an "illiquid fund" as a private fund that (i) is not required to redeem interests upon an investor's request and (ii) has limited opportunities, if any, for investors to withdraw before termination of the fund. This would include many private equity, real estate, credit and venture capital funds that are closed-ended and do not offer periodic redemption options, other than in exceptional circumstances.
    - The SEC simplified the definition of an "illiquid fund" as compared to the original proposal. Specifically, the SEC dropped the proposed requirements that an illiquid fund must: (i) have a limited life; (ii) not continuously raise capital; (iii) have as a predominant operating strategy the return of the proceeds from disposition of investments to investors; and (iv) not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments. As a result, certain closed-ended credit funds and real estate funds will more clearly fall under the "illiquid" designation.

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- The Rule defines "fund-level subscription facilities" as any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines or other indebtedness incurred by the private fund that is secured by the unfunded capital commitments of the private fund's investors. For performance measures *without* the impact of fund-level subscription facilities, advisers must calculate the performance measures as if the private fund called capital, as opposed to drawing on fund-level subscription facilities, and must exclude fees and expenses associated with the subscription facility, such as the interest expense. For performance measures *with* the impact of fund-level subscription facilities, advisers must calculate performance measures reflecting the actual capital activity from both investors and fund-level subscription facilities.
  - The SEC expressed its view in the adopting release that subscription facilities have the potential to increase performance metrics artificially.
  - The original proposal required disclosure *without* the impact of fund-level subscription facilities. In the adopting release, the SEC states that it ultimately required performance with *and* without such impact in order to provide investors with a more complete picture.
  - The SEC clarified in the adopting release that the definition of fund-level subscription facilities does not include fund guarantees of portfolio investment indebtedness.
- The Rule defines "internal rate of return" as the discount rate that causes the net present value of all cash flows throughout the life of the private fund to be equal to zero. Cash flows will be represented by capital contributions and fund distributions, and the unrealized value of the fund will be represented by a fund distribution.
- The Rule defines "multiple of invested capital" as (i) the sum of: (A) the unrealized value of the illiquid fund; and (B) the value of all distributions made by the illiquid fund, (ii) divided by the total capital contributed to the illiquid fund by its investors. This is intended to provide investors with a measure of the fund's aggregate value relative to the capital invested as of the end of the applicable reporting period.
- An adviser to an illiquid fund would also need to provide investors with a statement of contributions and distributions for the illiquid fund, which would present: (i) all capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund's inception, with the value and date of each inflow and outflow; and (ii) the net asset value of the private fund as of the end of the reporting period covered by the quarterly statement.
- In the adopting release, the SEC recommended that advisers include any fees and expenses related to a subscription facility. In addition, the SEC suggested that advisers consider providing additional details that they believe investors would see as relevant, such as information about how each contribution and distribution was used and the dates of drawdowns from fund-level subscription facilities.

Liquid funds

- An adviser to a liquid fund will need to show performance: (i) first, based on net total return on an annual basis for the ten fiscal years prior to the quarterly statement or since the fund's inception (whichever is shorter); (ii) second, based on its average annual net returns over one-, five- and ten-fiscal year periods; and (iii) third, based on the fund's cumulative net total return for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement.
- The Rule defines a "liquid fund" as any private fund that is not an illiquid fund (e.g., hedge funds that allow periodic investor redemptions).
- Net returns must be presented, although gross returns are permitted as well. If both net and gross are included, they must be presented with equal prominence. The SEC stated in the adopting release that it determined not to prescribe a definition for "net total returns."
- In a change from the proposed Rule, reporting will be based on fiscal year rather than calendar year reporting periods. In addition, in another change from the proposed Rule, advisers to funds with more than ten years of performance history are not required to report performance since inception. Liquid funds are permitted, but not required, to report performance on a longer horizon than ten years.

Mandatory private fund audits

The Rule requires registered advisers to private funds (including sub-advisers) to cause the private funds (other than securitized asset funds) to undergo an audit by an independent public accountant at least annually and upon liquidation. In the adopting release, SEC stated that audits would test assertions associated with the investment portfolio and provide a check against adviser misrepresentations of performance, fees and other information about the fund. Under the Rule, private fund audits must be conducted in accordance with the audit provision of the Custody Rule and advisers must

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meet the related requirements for delivery of audited financial statements under the Custody Rule. Specifically:

- The audit must be performed by an independent public accountant that meets the standards of independence in rule 2-01(b) and (c) of Regulation S-X that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the Public Company Accounting Oversight Board (PCAOB) in accordance with its rules;
- The audit must meet the audit definition in rule 1-02(d) of Regulation S-X;
- Audited financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP) or, in the case of financial statements of private funds organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States, must contain information substantially similar to statements prepared in accordance with U.S. GAAP, and material differences with U.S. GAAP must be reconciled; and
- Annually within 120 days of the private fund's fiscal year-end (or 180 days in the case of fund of funds) and promptly upon liquidation, the fund's audited financial statements must be distributed to all investors.
- For advisers not in a control relationship with the fund (e.g., an unaffiliated subadviser), the adviser is required the take all reasonable steps to cause the fund to undergo an audit consistent with the foregoing.
- *Key Clarifying Guidance*:
  - The SEC clarified that the SEC does not apply the mandatory audit requirement with respect to non-U.S. private funds of an SEC registered offshore investment adviser, and as such, difficulties of non-U.S. private fund advisers finding an auditor in certain jurisdictions should be reduced.
  - The SEC indicated that if an adviser to a pooled investment vehicle utilizes an SPV to facilitate investments, the adviser may either (i) treat the SPV as a separate client, in which case, the SPV will undergo a separate audit, with audited financial statements distributed to the pooled investment vehicle's beneficial owners or (ii) treat the SPV's assets as the pooled investment vehicle's assets, in which case the SPV's assets must be considered within the scope of the pooled investment vehicle's financial statement audit.
  - The SEC stated that if an adviser is unable to deliver audited financial statements in the time frame required due to "reasonably unforeseeable circumstances" (e.g., disruptions due to the COVID-19 pandemic), this would not provide a basis for enforcement action so long as the adviser reasonably believed the financial statements would be distributed by the deadline and the adviser delivers the financial statement as promptly as practicable.

Adviser-led secondaries

The Rule requires registered private fund advisers to obtain either a written fairness opinion or a valuation opinion from an independent opinion provider in connection with adviser-led secondary transactions. Advisers would also need to prepare a written summary of any material business relationships the adviser or any of its related persons has, or has had, within the two years immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider. Prior to the due date of the election form distributed to investors in respect of the adviser-led secondary transaction, the adviser would need to distribute the fairness opinion or valuation opinion, as applicable, and summary of material business relationships to all investors in the private fund.

- The Rule defines "adviser-led secondary transactions" as transactions initiated by the investment adviser or any of its related persons that offer the private fund's investors the choice between: (i) selling all or a portion of their interests in the private fund; and (ii) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.
  - Whether a transaction is "initiated by the adviser" would depend on the facts and circumstances, but the SEC notes that a transaction would generally qualify as such if the adviser commences a process, or causes one or more other persons to commence a process, that is designed to offer private fund investors the option to obtain liquidity for their private fund interests. According to the adopting release, the SEC would not view a secondary transaction as being initiated by an adviser if the adviser, at the unsolicited request of an investor, assists in a secondary sale of such investor's interest in a fund.
  - Because the definition of "adviser-led secondary transaction" requires a choice *between* selling interests in a private fund *and* converting/exchanging interests in a private fund for interests in another vehicle, transactions in which private fund investors are allowed to retain their interests in the same fund with respect to the underlying asset(s) on the same terms, such as many tender offer transactions, would generally be excluded from the definition of "adviser-led secondary transaction."

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- The Rule defines an "independent opinion provider" as one that (i) provides fairness opinions or valuation opinions in the ordinary course of its business and (ii) is not a related person of the adviser.
- Whether a business relationship between the adviser or any of its related persons and the independent opinion provider would be "material" would depend on the facts and circumstances. However, the SEC stated in the adopting release that audit, consulting, capital raising, investment banking, and other similar services would typically meet the standard for "materiality" for purposes of the Rule.

Restricted activities

In a modification from the proposed Rule, the Rule restricts (rather than prohibits) private fund advisers from engaging in certain activities, subject to satisfaction of certain disclosure and, in some cases, consent requirements. The proposed Rule had stated the SEC's belief that the proposed prohibited activities may result in fraud and investor harm by incentivizing advisers to place their interests ahead of their clients'. The adopting release notes that the SEC continues to believe the activities involve conflicts of interest and compensation schemes that are "contrary to the public interest and the protection of investors." However, the SEC believes the protective restrictions as adopted are reasonably designed to prevent fraud and deception.

The Rule applies to all investment advisers to private funds (not including a securitized asset fund but including exempt advisers) and generally provides either a disclosure-based exception or a disclosure- and consent-based exception for each restricted activity. Advisers to such private funds may not, directly or indirectly, engage in any of the following five restricted activities with respect to any private fund, or any investor in that private fund:

1. *Fees or Expenses of an Investigation*: Charging or allocating to a private fund fees or expenses associated with an investigation of the adviser or its related persons by governmental or regulatory authority, unless the adviser requests each investor of the private fund to consent to, and obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the adviser for, such charge or allocation; provided, however, that the adviser may not charge or allocate to the private fund fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Advisers Act or the rules promulgated thereunder (including a sanction pursuant to an order to which the adviser consented without admitting or denying the SEC findings). This restriction does not apply to certain grandfathered contractual arrangements, as discussed under "Grandfathering" below.

- *Key Clarifying Guidance*:
  - For purposes of requesting consent to this activity under the Rule, advisers generally should list each category of fee or expense as a separate line item, rather than grouping fund expenses into broad categories, and describe how each such fee or expense is related to the relevant investigation. Some commentators have predicted that the requirements for line-by-line accounting of expenses and for explanations of how expenses relate to the specific investigation may in some cases result in unwillingness by managers to seek this consent.
  - The SEC recognizes in the adopting release that governmental or regulatory bodies may not formally notify an adviser that it is under investigation and, in such a circumstance, whether an adviser is under investigation will be determined based on the information available.

2. *Fees or Expenses for Compliance or an Examination*: Charging or allocating to the private fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, of the adviser or its related persons, unless the adviser distributes a written notice of any such fees or expenses, and the dollar amount thereof, to the investors of such private fund client in writing within 45 days after the end of the fiscal quarter in which the charge occurs.

The Rule does not contain a definition of compliance fees or expenses, and this category may be construed broadly. Questions have arisen among industry participants relating to (i) expenses relating to Form PF filings and legal fees incurred in connection with an adviser receiving assistance from outside counsel in complying with the Rule itself (e.g., preparation of quarterly reports or disclosure of restricted activities) as well as (ii) fees and expenses associated with an examination of a portfolio company. Industry participants have also expressed concern regarding the possibility that disclosure requirements will require divulging sensitive commercial information to fund investors, for example, information that could be used to discern fee rates of compliance service providers.

- *Key Clarifying Guidance*:
  - The SEC has made clear that notice under the Rule should generally include a detailed accounting of each category of the relevant fees and expenses. Advisers should generally list each specific category of fee or expense as a separate line item and the dollar amount thereof, rather than group such fees and expenses into broad

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categories such as "compliance expenses."

3. *Non-Pro Rata Allocations*: Charging or allocating fees or expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons (other than a securitized asset fund) have invested (or propose to invest) in the same portfolio investment unless (i) the non-pro rata charge or allocation is fair and equitable under the circumstances and (ii) prior to charging or allocating such fees or expenses to a private fund client, the adviser distributes to each investor of the private fund a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances.

The SEC indicated in the adopting release that whether a non-pro rata allocation is "fair and equitable" will depend on factors relevant for the specific expense. The Rule does not define "pro rata," and the release acknowledges that there may be multiple methods to determine pro rata allocations. The SEC recognizes that the lack of a definition could result in subjectivity regarding how advisers calculate pro rata allocations and when an allocation is fair and equitable but believes that this framework will provide additional investor protection. The lack of clarity regarding these concepts may introduce additional compliance risk for advisers.

It has been noted by industry commenters that the requirement to provide disclosures regarding non-pro rata allocations in advance may lead to advisers delaying when relevant amounts are actually charged or allocated to private funds in order to synchronize the timing of such disclosures with the timing of quarterly or annual reports.

- *Key Clarifying Guidance*:
  - The SEC provides examples in the adopting release of certain factors that may indicate that a non-pro rata allocation is "fair and equitable," e.g., whether the expense relates to a specific type of security that one private fund client holds, whether the expense relates to a bespoke structuring arrangement for one private fund client to participate in the portfolio investment or whether one private fund client may receive a greater benefit from the expense relative to other private fund clients, such as the potential benefit of certain insurance policies.
  - The adopting release notes that in some instances a fund may not have the resources to bear a pro rata share of expenses relating to a portfolio investment, including as a result of insufficient reserves or the inability to call capital to cover the expenses. The SEC appears to suggest possible ways to address such a case, including by the adviser paying such a fund's pro rata portion of any fee or expense with its own capital or diluting such fund's interest in the portfolio investment in a manner that is fair and equitable, subject to applicable laws, rules or regulations and applicable provisions of the fund's governing documents.
- The release cites co-investment vehicles as, at times, being inappropriately advantaged over main fund vehicles in relation to allocation of fees and expenses. We expect that co-investment vehicles will be an area of particular challenge, and advisers may delay allocations of expenses that need to be apportioned on a non-pro rata basis.

4. *Clawback Reductions for Taxes*: Reducing the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders, unless the adviser distributes a written notice to the investors of the relevant private fund client that sets forth the aggregate dollar amounts of the adviser clawback before and after any reduction for actual, potential, or hypothetical taxes within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.

- The Rule defines "adviser clawback" as 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. It defines "performance-based compensation" as any allocations, payments or distributions of capital based on the private fund's (or its portfolio investments') capital gains, capital appreciation and/or other profit.

The SEC has noted in the adopting release that the aggregate gross dollar amounts provided in an adviser clawback notice should reflect the gross amount of excess compensation (not reduced by any taxes paid or deemed paid by the recipients or other persons on their behalf) received by the adviser (or its related persons) that is being clawed back. The aggregate after tax dollar amounts disclosed should be reduced by taxes paid or deemed paid by the recipients or other persons on their behalf. These required disclosures may be included in the adviser's quarterly or annual statements if the adviser is subject to the quarterly statement requirement and to the extent that the quarterly statement is delivered within 45 days following the end of the relevant fiscal quarter.

5. *Borrowing from a Private Fund Client*: Borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client unless the adviser: (i) distributes to each investor a written description of the material terms of, and requests each investor to consent to, such borrowing, loan, or extension of credit; and (ii) obtains written consent from at least a majority in interest of the private fund's investors that are not related persons of the

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adviser.

The SEC notes that the Rule does not enumerate specific terms of the borrowing that must be disclosed in connection with an adviser's consent request. Instead, the Rule simply requires advisers to disclose the prospective borrowing and the material terms related to the borrowing. The borrowing amount, interest rate and repayment schedule may be considered material, depending on facts and circumstances. This restriction does not apply to certain grandfathered contractual arrangements, as discussed under "Grandfathering" below.

– *Key Clarifying Guidance*:
  - The borrowing restriction does not apply to borrowings from a third party on the fund's behalf or to the adviser's borrowings from individual investors outside of the fund.
  - The adopting release clarifies that neither ordinary course tax advances (i.e., ones that are not structured to include the repayment of advanced amounts to the fund, but only the reduction in future income to be received by the adviser) nor management fee offsets are borrowings that are subject to the Rule.

In the adopting release, the SEC provides guidance regarding obtaining the advance investor consent required in connection with the restricted activities in items 1 and 5 above. The release specifies that each consent-based exception will require an adviser to seek advance consent for the restricted activity from all of the fund's investors and obtain consent from at least a majority in interest of investors that are not related persons of the adviser. The release notes that a fund's governing documents may establish that a higher threshold of investor consent is necessary in order for the adviser to engage in these restricted activities and may generally prescribe the manner and process by which the applicable threshold of investor consent is obtained. The adopting release cites funds that have both voting and nonvoting classes of interests and those that exclude defaulting investors from votes as examples. However, the release also states that it must be fund investors that vote, and not other fund governance bodies such as limited partner advisory committees, advisory boards or boards of directors. The guidance does not indicate whether or not consent can be obtained via a negative consent mechanism if one is set out in the fund's governing documents.

Prohibitions not adopted

Two proposed rules regarding prohibited activities were not adopted as part of the Rule. These were the prohibitions on an adviser (i) charging certain fees and expenses to a portfolio investment, including monitoring fees or certain other fees, in respect of any services the adviser does not, or does not reasonably expect to, provide to the portfolio investment and (ii) seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors, directly or indirectly, for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.

With respect to the proposed prohibition on charging fees to a portfolio investment in respect of services the adviser does not or does not reasonably expect to provide, the SEC declined to adopt the rule because the SEC determined it was unnecessary, given that such activities are inconsistent with an adviser's existing duties to clients under the Federal fiduciary duty. The SEC indicates in the adopting release that, to the extent an adviser does not ultimately provide services, the adviser would be required by its duties and obligations to refund any prepaid amounts attributable to the unperformed services.

Similarly, with respect to the proposed waiver or indemnification prohibition, the SEC declined to adopt the rule in part because it believes that the prohibition is not necessary to address the practice. Instead, the SEC reminded advisers in the adopting release of their Federal fiduciary duty and their legal obligations under the Advisers Act, including the anti-fraud provisions. The SEC also stated its belief that a waiver of an adviser's compliance with the Advisers Act, or rules thereunder, is invalid under the Advisers Act.

– *Key Clarifying Guidance*:
  - The adopting release contains examples of how the SEC's interpretation of the Advisers Act in relation to waivers and indemnification applies to certain facts and circumstances. Specifically, the adopting release states that an adviser violates the antifraud provisions of the Advisers Act when (i) there is a contract provision waiving "any and all" of the adviser's fiduciary duties (but, for Advisers Act purposes, it may be acceptable to waive state fiduciary duties if it is clear that Federal fiduciary duties are not waived) or (ii) there is a contract provision explicitly or generically waiving the adviser's Federal fiduciary duty, if there is no language clarifying that the adviser is not waiving its Federal fiduciary duty or that the client retains certain non-waivable rights (i.e., a "savings clause").

Preferential treatment/side letters

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Private fund advisers (whether or not registered with the SEC) will not be permitted to provide preferential terms to only certain investors in a private fund (other than securitized asset funds) regarding redemptions (other than as required by law) or information about portfolio holdings or exposures (e.g., through side letters or to certain investors only through the fund's governing documents) if the adviser reasonably expects that doing so would have a material, negative effect on other investors in the private fund or in a "similar pool of assets" without providing those same rights to all other investors (as further described below). Private fund advisers will also be prohibited from providing preferential treatment unless the adviser discloses preferential treatment related to material economic terms in writing to prospective investors prior to investment and all preferential treatment to current investors at the times described below.

- *Certain Prohibited Preferential Redemptions*: Private fund advisers and their related persons will be prohibited from directly or indirectly granting an investor in a private fund or in a similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a similar pool of assets (e.g., certain preferential redemption rights and liquidity terms for parallel vehicles), except (i) if such ability to redeem is required by applicable laws, rules, regulations or orders of any relevant foreign or U.S. government, state or political subdivision to which the investor, the private fund or the similar pool of assets is subject or (ii) if the adviser has offered the same redemption ability to all other existing investors, and will continue to offer such redemption ability to all future investors, in the private fund and any similar pool of assets without qualification. This restriction does not apply to certain grandfathered contractual arrangements, as discussed under "Grandfathering" below.
  - *Key Clarifying Guidance*:
    - In the adopting release, the SEC stated that the "reasonably expects" standard does not require advisers to predict whether a preferential redemption right will have a material, negative effect on other investors but, rather, it "requires advisers to form only a reasonable expectation based on the facts and circumstances" at the time the preferential term is granted.
    - The SEC also stated in the adopting release that, as an example, the SEC believes that "an adviser could form a reasonable expectation that certain redemption terms would have a material, negative effect on other fund investors if a majority of the portfolio investments were not likely to be liquid."
    - As an example, selling a fund's liquid assets to accommodate a redemption request from an investor that was granted a preferred redemption right could reduce the fund's pool of liquid assets, and negatively affect the fund's ability to execute its investment strategy, satisfy other redemption requests, and dilute other investor's interests.
    - The SEC also made clear that preferential redemption terms granted due to an investor's internal policies or resolutions do not fall within the "applicable law exception" to the Rule.

- *Certain Prohibited Preferential Transparency*: Private fund advisers and their related persons will be prohibited from providing information regarding the portfolio holdings or exposures of a private fund or of a similar pool of assets to any investor in the private fund if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets, except if the adviser offers such information to all existing investors in the private fund and any similar pool of assets at the same time or substantially the same time. This restriction does not apply to certain grandfathered contractual arrangements, as discussed under "Grandfathering" below.
  - *Key Clarifying Guidance*:
    - In the adopting release, the SEC noted that the exception to the prohibition on providing preferential information should allow advisers to discuss information on portfolio holdings during investor meetings so long as all investors have access to the same information.
    - In the adopting release, the SEC stated that the "reasonably expects" standard does not require advisers to predict whether a preferential information right will have a material, negative effect on other investors but, rather, it "requires advisers to form only a reasonable expectation based on the facts and circumstances" at the time the preferential term is granted.
    - As an example, selective disclosure of certain information to an investment may help that investor avoid a loss (by requesting a redemption) at the expense of other investors that do not receive the same information, which may constitute a material, negative effect on other investors, because that information may allow the investor to "front-run" or otherwise disadvantage the fund or other clients of the adviser.
    - The SEC stated that the ability to redeem is important to the determination as to whether providing information would have a material, negative effect on other investors and, therefore, preferential information rights granted

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to investors in an illiquid private fund would generally not be viewed as having a material, negative effect on other investors.

  - The SEC, however, declined to adopt a blanket exemption for illiquid private funds because some illiquid private funds do offer redemption rights in response to regulatory events (e.g., redemptions related to the Employee Retirement Income Security Act and the Bank Holding Company Act) and other extraordinary circumstances (e.g., redemptions related to a violation of a State pay-to-play law).

- *Similar Pool of Assets*: The Rule defines the term "similar pool of assets" as a pooled investment (other than an investment company registered under the Investment Company Act of 1940, a company that elects to be regulated as such, or a securitized asset fund) with substantially similar investment policies, objectives or strategies to those of the private fund managed by the adviser or its related persons. Whether a pool of assets managed by the adviser is "substantially similar" to the private fund requires a facts and circumstances analysis.
  - *Key Clarifying Guidance*:
    - According to the adopting release, the types of asset pools captured by this term include limited liability companies, partnerships and other organizational structures, regardless of number of investors, feeders to the same master fund; parallel fund structures, co-investment vehicles and alternative investment vehicles as well as pooled vehicles with different base currencies and pooled vehicles with embedded leverage to the extent such pooled vehicles have substantially similar investment policies, objectives, or strategies as the subject private fund.
    - An adviser will be required to consider whether any proprietary vehicles is a similar pool of assets.
    - The adopting release notes, though, that a pool of assets with a materially different target return or sector focus would likely not have substantially similar investment policies, objectives or strategies as the subject private fund, depending on the facts and circumstances.

- *All Preferential Treatment Disclosure*: In addition, private fund advisers and their related persons will be prohibited from providing certain preferential terms to any investor in a private fund (other than a securitized asset fund) unless the adviser provides certain written disclosures to prospective and current investors. The adviser will be required to provide each prospective investor in the fund a written notice that provides specific information regarding preferential treatment related to any material economic terms that is being provided to other investors in the same private fund prior to each prospective investor's investment in the private fund.

  For an existing investor in an illiquid fund, the adviser will be required to provide written disclosure as soon as reasonably practicable following the end of the private fund's fundraising period to all private fund investors of all preferential treatment that has been provided to other investors in the same private fund.

  For an existing investor in a liquid fund, the adviser will be required to provide written disclosure as soon as reasonably practicable following an investor's investment in the private fund to the investor of all preferential treatment that has been provided to other investors in the same private fund.

  In addition, for both illiquid and liquid funds, the adviser will be required to provide written notice specifying any preferential treatment provided to other investors in the same private fund (including any transferees) since the last written notice provided in accordance with the above.

- *Key Clarifying Guidance*:
  - "Material economic terms" includes, but is not limited to, the cost of investing, liquidity rights, fee breaks and co-investment rights.
  - Whether a written notice is provided "as soon as reasonably practicable" will depend on the facts and circumstances rather than a specific time limit.
  - The adopting release stated that it would generally be appropriate for advisers to distribute the notices within four weeks.
  - An adviser could comply with the proposed disclosure requirements by providing copies of side letters (redacting identifying information) or a written summary of the preferential terms granted to investors in the same private fund specifically describing the preferential treatment.
  - A private fund that does not admit new investors or provide new terms to existing investors after the previous notice does not need to deliver a new annual notice.

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Books and records

The Rule amends rule 204-2 (the books and records rule) under the Advisers Act to require advisers to retain records related to the new Rule. The Rule requires private fund advisers to:

- With respect to the quarterly statement rule:
  - Retain a copy of any quarterly statement distributed to fund investors pursuant to the quarterly statement rule, as well as a record of each addressee, and the date(s) the statement was sent.
  - Retain all records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers and performance listed on any quarterly statement delivered pursuant to the quarterly statement rule.
  - Retain documentation substantiating the adviser's determination that the private fund it manages is a liquid fund or an illiquid fund pursuant to the quarterly statement rule. In addition, if an adviser changes its determination of whether a fund is a liquid fund or an illiquid fund, it should keep documentation substantiating determination of such change.
- With respect to the audit rule, retain a copy of any audited financial statements, along with a record of each addressee and the corresponding date(s) sent. The adviser is also required to keep a record documenting steps taken by the adviser to cause a private fund client with which it is not in a control relationship to undergo a financial statement audit that would comply with the mandatory audit rule.
- With respect to the adviser-led secondaries rule, retain copies of the fairness opinion (or valuation opinion) and material business relationship summary distributed to investors, as well as a record of each addressee and the date(s) sent.
- With respect to the restricted activities rule, retain copies of any notification, consent, or other document distributed to or received from private fund investors pursuant to this rule, along with a record of each addressee and the corresponding date(s) sent for each such document distributed by the adviser.
- With respect to the preferential treatment rule, retain all written notices sent to current and prospective investors in a private fund pursuant to the preferential treatment rule. In addition, advisers are also required to retain copies of a record of each addressee and the corresponding date(s) sent.

Grandfathering

Legacy status applies to (i) the restrictions under the Rule that preclude an adviser from borrowing from a private fund client or charging or allocating to a private fund fees or expenses associated with an investigation without investor consent and (ii) the restrictions on preferential treatment with respect to certain redemption and information rights. That is, a grandfathered portion of the Rule will not apply with respect to contractual agreements governing a private fund (and, with respect to borrowing, contractual agreements governing a borrowing, loan, or extension of credit entered into by a private fund) that has commenced operations as of the applicable compliance date and that were entered into in writing prior to the compliance date, but only if such portion of the Rule would require the parties to amend the relevant fund's governing agreements. Industry participants have noted that such amendments will likely not be necessary in many cases, thus limiting the benefit of legacy status.

- *Key Clarifying Guidance*:
  - Legacy status for charging or allocating to a private fund fees or expenses associated with an investigation without investor consent will not permit an adviser to such a private fund to charge or allocate to such fund fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Advisers Act.

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[1] The Rule provides an exception for "securitized asset funds" which are excluded from the definition of private fund for purposes of the Rule and which is defined as "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders."

[2] The definition, in addition, provides that: (i) each of an investment adviser's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control the investment adviser; (ii) a person is presumed to control a corporation if the person: (A) directly or indirectly has the right to vote 25% or more of a class of the corporation's voting securities; or (B) has the power to sell or direct the sale of 25% or more of a class of the corporation's voting securities; (iii) a person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the partnership; (iv) a person is presumed to control a limited liability company if the person: (A) directly or indirectly has the right to vote 25% or more of a class of the interests of the limited liability company; (B) has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the limited liability company; or (C) is an elected manager of the limited liability company; or (v) a person is presumed to control a trust if the person is a trustee or managing agent of the trust.

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