The SEC's Private Fund Rules: What Advisers Need to Know

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On August 23, 2023, the U.S. Securities and Exchange Commission (SEC) adopted new rules (Adopting Release) for private fund advisers under the Investment Advisers Act of 1940, as amended (Advisers Act).[1] Under the new rules, registered private fund advisers must: (1) provide quarterly statements to fund investors with details on performance, fees and expenses; (2) obtain an annual audit for private funds; and (3) comply with certain requirements for adviser-led secondaries, including obtaining a fairness opinion or valuation opinion. The rule heightens regulation for all private fund advisers, regardless of registration status, by establishing certain requirements. Under the final rules, private fund advisers are restricted from engaging in several activities that are viewed as contrary to public interest and protection of investors. These provisions apply to all private fund advisers, whether registered or exempt, with respect to private funds they advise (other than a securitized asset fund).

To engage in restricted activities, advisers will need to comply with the conditions set forth in the rule as well as any applicable provisions of their fund documents, which may be more restrictive or prohibitive in nature. As further discussed below, the restricted activities include activities related to certain fees and expenses, clawbacks, non-prorata fees, and borrowing from a fund. Additionally, all private fund advisers are prohibited form providing preferential terms to investors regarding certain redemptions from the fund, unless the ability to redeem is required by applicable law or the adviser offers the preferential redemption rights to all investors without qualification; and certain preferential information about portfolio holdings or exposures, unless such preferential information is offered to all investors. The SEC also amended existing Advisers Act Rules 204-2 (the Books and Records Rule), and rule 206(4)-7, which are discussed below. The new rules are incredibly complex and the devil is in the details, some of the more significant of which are discussed below.

According to the SEC's rule fact sheet[2], the reforms are designed to protect those direct and indirect private fund investors by increasing visibility into certain adviser practices, establishing requirements to address practices that have the potential to lead to investor harm, and prohibiting or restricting adviser activity that is contrary to the public interest and the protection of investors.

While the final rules relax some of the requirements the SEC included in its proposed rule, the final rules will significantly increase regulatory requirements for private fund advisers. These changes come at a time when many CCOs and compliance professionals are experiencing regulatory fatigue and numerous additional proposals still on the SEC's regulatory agenda.

Background

The private fund rules were initially proposed on February 9, 2022,[3] and were met with significant industry pushback. Even those investors for whom the rules were designed to protect expressed concerns regarding the proposal's lack of clarity and unintended consequences, although they generally applauded the SEC's efforts to increase transparency.[4]

NSCP submitted a comment letter strongly supporting the Commission's efforts to protect investors, but noting specific significant concerns about the lack of clarity in the proposed rules

1. *See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance*, SEC Release No. IA-6383 (Aug. 23, 2023), available at: https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.
2. *Fact Sheet: Private Fund Adviser Reforms: Final Rules*, U.S. Securities and Exchange Commission, available at https://www.sec.gov/files/ia-6383-fact-sheet.pdf.
3. *See* Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Rel. No. IA-5955, 87 FR 16886 (pub. March 24, 2022), available at: https://www.sec.gov/files/rules/proposed/2022/ia-5955.pdf.
4. *See* Comment Letter from Institutional Limited Partners Association ("ILPA") (Apr. 26, 2023), available at: https://www.sec.gov/comments/s7-26-22/s72622-20165136-334499.pdf *(SEC should prohibit contractual provisions that expressly limit or purport to waive fiduciary duties where such a limit or waiver would result in a contractual standard of care that is inconsistent with an adviser's' duty under the Advisers Act."*); Comment Letter from Jase Auby, CIO, Teacher Retirement System of Texas (Dec. 13, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20152703-320446.pdf (*expressing concern that the rule concerning preferential treatment as proposed could have unintended consequences*); Comment Letter from Illinois Federation of Teachers (Apr. 27, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20127400-288469.pdf; and Comment Letter from National Conference on Public Employee Retirement Systems (NCPERS) (Apr. 25, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20124991-282966.pdf.

and the significant additional burden they would place on compliance in general, if adopted as proposed.[5]

Many commenters expressed fear that the additional regulation would increase costs, curtail private fund investment, and adversely affect investors who benefit from such investments, as well as negatively impact capital formation and market function generally. Notably, many in the

industry expressed grave concern about the number and pace of interconnected rule proposals issued by the SEC since it proposed the private fund rules in 2022.[6] A number of comment letters claimed the SEC failed to conduct a comprehensive cost-benefit analysis of the proposed private fund rules in light of the other interconnected rule proposals.[7] Some industry participants are particularly concerned that the coming steeper compliance costs and demands will drive smaller funds, including minority and women-run funds, out of the market.[8]

Some commenters and industry participants have gone so far as to claim the SEC's rulemaking approach could be a violation of its obligations under the Administrative Procedures Act and inconsistent with its statutory mission.

Nevertheless, the SEC adopted final rules on August 23, 2023, and published the rules in the Federal Register on September 14, 2023. The final rules imposed sweeping changes on private fund advisers; however, following the significant industry pushback described above, the final version of the rules is less transformational than as initially proposed. The final rules include new Advisers Act Rules 206(4)-10, 211(h)(1)-1, 211(h)(1)-2, 211(h)(2)-1, 211(h)(2)-2, and 211(h)(2)-3, which are only applicable to private fund advisers. As discussed in greater detail below, in addition to these private fund-only parts of the final rules, several new rules apply to all private fund advisers, including exempt reporting advisers. More specifically, these are: amendments to existing Advisers Act Rules 204-2 (books and records) and 206(4)-7 (compliance procedures and practices), which apply not only to private fund advisers, but to all SEC registered advisers (and those required to be registered) — regardless of whether they have private fund clients.

Overview of the Adopted Private Fund Adviser Rules

While several the new rules essentially codify industry best practices and SEC guidance, a few of the new requirements could increase private fund advisers' operating costs, particularly with respect to smaller private fund advisers.[9]

Definitions Rule – 211(h)(1)-1. New Rule 211(h)(1)-1 contains numerous definitions for purposes of the other new rules adopted by the SEC under Advisers Act Section 211(h) and, as discussed below, including (but not limited to) the terms "adviser clawback," "adviser-led secondary transaction," "Gross IRR," and "Gross MOIC." Clearer, standardized definitions on performance reporting may be a welcome change from the SEC's relatively new Marketing Rule (Advisers Act Rule 206(4)-1), which does not prescribe any particular calculation of gross or net performance for advertisements. According to the adopting release, the SEC believes prescribing standardized

5. *See* Comment Letter from Lisa Crossley, NSCP Executive Director and CEO, National Society of Compliance Professionals (Apr. 19, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20124162-280557.pdf.
6. *See* Comment Letter from Rebekah Goshorn Jurata, General Counsel, American Investment Council(Aug. 8, 2023), available at: https://www.sec.gov/comments/s7-03-22/s70322-245759-509782.pdf. These interconnected rule proposals include but not limited to the updates to Form PF, the updates to the custody rule, the outsourcing proposal, and the ESG-related proposals.
7. *See* Comment Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, Managed Funds Association (Jul. 24, 2023), available at: https://www.sec.gov/comments/s7-03-22/s70322-233122-486744.pdf; Comment Letter from Bill Huizenga, Chairman, Subcommittee on Oversight and Investigations, House Financial Services Committee and Steve Womack, Chairman, Subcommittee on Financial Services and General Government House Appropriations Committee (Jul. 6, 2023) ("Huizenga Womack Letter"), available at: https://www.sec.gov/comments/s7-03-22/s70322-220759-464282.pdf.
8. *See* Huizenga Womack Letter; Comment Letter from Committee on Capital Markets Regulation (May. 25, 2023), available at: https://www.sec.gov/comments/s7-03-22/s70322-194719-386922.pdf; Comment Letter from Committee on Capital Markets Regulation (Apr. 12, 2023), available at: https://www.sec.gov/comments/s7-03-22/s70322-20164111-334040.pdf (stating, the Proposed Rule will also increase barriers to entry to the U.S. private equity fund market with a particularly negative impact on women and minority-led private equity fund advisers).
9. *See* Comment Letter from Lisa Crossley, NSCP Executive Director and CEO, National Society of Compliance Professionals (Apr. 19, 2022), available at: https://www.sec.gov/comments/s7-03-22/s70322-20124162-280557.pdf.

performance metrics will allow private fund investors to compare more easily the returns of similar fund strategies over different market environments and over time. The quarterly reports are also expected to help ensure disclosure of fees and expenses, and the corresponding dollar amounts, to current investors so they can understand and assess the cost of their private fund investments. In particular, the SEC is hoping the fee and expense reporting will help investors monitor effectively whether any fee and expense misallocations are occurring and to respond effectively. However, the mandatory methodology will require all private fund advisers to review their existing practices and make necessary adjustments, which may be challenging for those managing certain strategies or using non-traditional performance calculations.

Quarterly Statements Rule – 211(h)(1)-2. *SEC Registered private fund advisers (and those required to be registered*) to a private fund (other than a securitized asset fund[10]) that has at least two full fiscal quarters of operating results must prepare and distribute a quarterly statement to the investor in those private funds, within 45 days after the end of each of the first three fiscal quarters of each fiscal year of the private fund and 90 days after the end of each fiscal year of the private fund[11]. Such statements must include certain standardized disclosures on the cost of investing in the private fund and the private fund's performance. The quarterly statement also must include prominent disclosure on the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated, and include cross references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology. Specifically, the statement must include:

- **Fund Table**. The following information must be presented both before and after the application of any offsets, rebates, or waivers:
    - A detailed accounting of all compensation, fees, and other amounts allocated or paid to the private fund 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, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation;
    - A detailed accounting of all fees and expenses allocated to or paid by the private fund during the reporting period (other than those listed above), with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and
    - The amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future payments or allocations to the private fund adviser or its related persons.
- **Portfolio Investment Table**. The quarterly statement must include a separate table for the private fund's covered portfolio investments that discloses, at a minimum, the following information for each covered portfolio investment: a detailed accounting of all portfolio investment compensation allocated or paid to the private fund adviser or any of its related persons by the covered portfolio investment during the reporting period, with separate line items for each category of allocation or payment reflecting

10. The Quarterly Statement Rule, Private Fund Audit Rule, Adviser-Led Secondaries Rule, Restricted Activities Rule, and Preferential Treatment Rule do not apply to private fund advisers with respect to "securitized asset funds" they advise, which is defined as any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders. This definition is based on the corresponding definition for "securitized asset fund" in Form PF and Form ADV, and is designed to capture vehicles established for the purpose of issuing asset backed securities, such as collateralized loan obligations.
11. If the private fund is a fund of funds, a quarterly statement must be distributed within 75 days after the end of the first three fiscal quarters of each fiscal year and 120 days after the end of each fiscal year..

the total dollar amount, presented both before and after the application of any offsets, rebates, or waivers.

- **Performance Table**. The performance disclosure requirements require a private fund adviser first to determine whether its private fund client is an illiquid or liquid fund, as defined in the rule, no later than the time the private fund adviser sends the initial quarterly statement. Final Rule 211(h)(1)-1 defines "illiquid fund" as a private fund that (i) is not required to redeem interests upon an investor's request, and (ii) has limited if any, for investors to withdraw before termination of the private opportunities fund. "Liquid fund" is defined as any private fund that is not an illiquid fund. In the Adopting Release, the SEC noted that, generally, if a private fund allows voluntary

  redemptions/withdrawals, then it is a liquid fund. The SEC further noted that private funds that fall into the "illiquid fund" definition are generally closed-end funds that do not offer periodic redemptions/withdrawal options other than in exceptional circumstances (e.g., most private equity and venture capital funds). The quarterly statement must present the following with equal prominence[12]. The SEC adopted a narrower definition than initially proposed, noting that it "believe[s] that redemption and withdrawal capability represents the distinguishing feature between illiquid and liquid funds."[13]

Private equity funds and other similar funds will be deemed to be illiquid so long as redemption opportunities are limited. Importantly, footnote 631 of the adopting release for the private fund rules makes clear that the SEC's Marketing Rule would generally not apply to information required to be included in a quarterly statement. However, if an adviser chooses to include additional information in a quarterly statement, such information may be subject to the Marketing Rule. Also, if the same required information is presented outside of the quarterly statement, the information in that different context may be subject the Marketing Rule.[14] The biggest difference from the Marketing Rule's approach to performance is that the Quarterly Statements rule requires liquid funds (as defined below) to report private fund performance over one-, five-, and 10-year periods. Indeed, in the final Marketing Rule's adopting release, the SEC specifically excepted private funds from that prescribed time period requirement for performance advertisements and stated, "requiring advisers to provide performance results of private funds over one-, five-, and ten-year periods in advertisements will not provide investors with useful insight into how the advertised portfolio(s) performed during different market or economic conditions."[15]

- For a liquid fund:
  - Annual net total returns for each fiscal year over the past 10 fiscal years or since inception, whichever time period is shorter;
  - Annual net total returns over the one-, five-, and 10-fiscal-year periods; and
  - 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.

12. The quarterly statement must also include the date as of which the performance information is current through, and prominent disclosure of the criteria used and assumptions made in calculating the performance.
13. *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance*, SEC Release No. IA-6383 at 112 (Aug. 23, 2023), available at: https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.
14. The final Marketing Rule adopting release states that information in a statutory or regulatory notice, filing, or other required communication would be excluded from the definition of an "advertisement," provided the information is reasonably designed to satisfy the requirements. However, if an adviser includes information that is not reasonably designed to satisfy its obligations under applicable law, and such additional information offers the adviser's investment advisory services with regard to securities, then that information will be considered an "advertisement" for purposes of the rule. See https://www.sec.gov/rules/final/2020/ia-5653.pdf.
15. In the adopting release, the SEC noted, "Although there are commonalities between the performance reporting elements of the final rule and the performance elements of our recently adopted marketing rule, the two rules have different purposes that stem from the needs of the different types of clients and investors they seek to protect. While the marketing rule is focused on prospective clients and investors, the quarterly statement rule is focused on current clients and investors. All clients and investors should be protected against misleading, deceptive, and confusing information, but current clients and investors have different needs from those of prospective clients and investors." *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance*, SEC Release No. IA-6383 at 105 (Aug. 23, 2023), available at: https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.

- For an illiquid fund:
    - The following performance measures, shown since inception of the illiquid fund through the end of the quarter covered by the quarterly statement and computed with and without the impact of any fund-level subscription facilities: (1) gross IRR and gross MOIC for the illiquid fund; (2) net IRR and net MOIC for the illiquid fund; and (3) gross IRR and gross MOIC for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately; and
    - A statement of contributions and distributions for the illiquid fund.

As discussed in a number of the comment letters, the Quarterly Statement rule is expected to increase operating costs for private fund managers. As further discussed below, allocation of expenses associated with preparing these required quarterly reports can be allocated to the fund if certain conditions are met and the fund governing documents permit such expenses to be allocated to the fund. Also, certain industry groups offer reporting templates that may help minimize costs; however, advisers should proceed with caution and confirm templates they are using in fact meet the rule's reporting requirements.

Private Fund Audit Rule – 206(4)-10. *Private fund advisers registered or required to be registered with the SEC* must cause each private fund that they advise (other than a securitized asset fund), directly or indirectly, to undergo a financial statement audit (as defined in rule 1-02(d) Regulation S-X) that meets the requirements of limited partnership annual audits as set forth in the Custody Rule (Rule 206(4)-2(b)(4)) and must deliver audited financial statement in accordance with the Custody Rule (Rule 206(4)-2(c)), if the private fund does not otherwise undergo such an audit. For a private fund (other than a securitized asset fund) that the private fund adviser does not control and is neither controlled by nor under common control with, the private fund adviser will be prohibited from providing investment advice to the private fund if the private fund adviser fails to take all reasonable steps to cause the private fund to undergo a financial statement audit, and to cause audited financial statements to be delivered, in the same manner as discussed above.

On a related note, and in light of the Adopting Release, on August 23, 2023, the SEC reopened the comment period on its proposed rule that would amend and redesignate the current Custody Rule as the new Safeguarding Rule 223-1.[16] The reopened comment period closed on October 30, 2023.[17]

Adviser-Led Secondaries Rule – 211(h)(2)-2. *Private fund advisers registered or required to be registered with the SEC* conducting an adviser-led secondary transaction with respect to any private fund that it advises (other than a securitized asset fund) must meet the following requirements prior to the due date of the election form in respect of the adviser-led secondary transaction: (1) obtain and distribute to investors in the private fund, a fairness opinion or valuation opinion from an independent opinion provider; and (2) prepare and distribute, to investors in the

private fund, a written summary of any material business relationships the private fund adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider.

For purposes of the rule, "adviser-led secondary transaction" means any transaction initiated by the private fund adviser or any of its related persons that offers private fund investors the

16. *See*, Safeguarding Advisory Client Assets; Reopening of Comment Period, SEC Release No. IA-6384 (Aug. 23, 2023), available at: https://www.sec.gov/files/rules/proposed/2023/ia-6384.pdf; Safeguarding Advisory Client Assets, Release No. IA-6240 (Feb. 15, 2023), available at: https://www.sec.gov/files/rules/proposed/2023/ia-6240.pdf.
17. For more information, see comment letter, dated May 11, 2023, from Lisa Crossley, NSCP Executive Director and CEO, National Society of Compliance Professionals at https://www.sec.gov/comments/s7-04-23/s70423-188499-343742.pdf.

choice between: (1) selling all or a portion of their interests in the private fund; and (2) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the private fund adviser or any of its related persons.

In a change from the proposed rule, the final rule gives private fund advisers the option to obtain and distribute a valuation opinion instead of a fairness opinion. In response to commenters' concerns about the cost of a fairness opinion, the SEC made the modification to include the valuation opinion option because "a valuation opinion would also provide a third-party check on valuation, which is critical to addressing the conflicts of interest inherent in adviser-led secondary transactions."[18]

The adopting release confirms private fund advisers could allocate the costs of obtaining a fairness opinion or valuation opinion to the fund, assuming sufficient disclosure is provided to investors and the fund governing documents otherwise permit such expense allocation. Alternatively, advisers could "attempt to introduce" increased management fees or other charges to cover such costs.

Restricted Activities Rule – 211(h)(2)-1. In significantly departing from its proposal, the SEC modified its proposed rule that would have flatly prohibited certain activities, to restrict certain activities, subject to disclosure and consent requirements, which is more in line with historical practice. *All private fund advisers* — ***whether registered or exempt*** — with respect to private funds they advise (other than a securitized asset fund) are prohibited from, directly or indirectly:

- Charging or allocating to the private fund fees or expenses associated with an investigation of the private fund adviser or its related persons by any governmental or regulatory authority, unless the private fund adviser requests the written consent of each private fund investor and obtains such consent from at least a majority in interest of the private fund's investors that are not related persons of the private fund adviser; provided, however, a private fund adviser may not charge or allocate 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 thereunder;

- Charging or allocating to the private fund any regulatory or compliance fees or expenses, or fees or expenses associated with an examination, of the private fund adviser or its related persons, unless the private fund adviser distributed a written notice of any such fees or expenses, and the dollar amount thereof, to the private fund investors within 45 days after the end of the fiscal quarter in which the charge occurs[19];

- Reducing the amount of a private fund adviser clawback by actual, potential, or hypothetical taxes applicable to the private fund adviser, its related persons, or their respective owners or interest holders, unless the private fund adviser sends written notice to the private fund investors that includes the aggregate dollar amounts of the 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 clawback occurs;

- 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 private fund 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

18. *See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance*, SEC Release No. IA-6383 at 196 (Aug. 23, 2023), available at: https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.
19. This prohibition will not apply with respect to contractual agreements governing a private fund that has commenced operations as of the compliance date (as discussed below) and that were entered into in writing prior to the compliance date if such prohibition would require the parties to amend such governing agreements.

(ii) prior to charging or allocating such fees or expenses to a private fund client, the private fund adviser distributed to each private fund investor a written notice of the non-pro rata charge or allocation and a description of how it is fair and equitable under the circumstances; and

- Borrowing money, securities, or other private fund assets, or receiving a loan or an extension of credit, from a private fund client, unless the private fund adviser: (i) distributed 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 private fund adviser.[20]

To engage in restricted activities adviser will need to comply with the conditions set forth in the rule as well as any applicable provisions of their fund documents, which may be more restrictive or prohibitive in nature (for example expense provisions which may or may not authorize the allocation of adviser compliance costs to the fund). The fact that each rule requires a somewhat different path to compliance, which may be different than the required process set forth in the relevant fund's limited partnership agreement, makes these restricted activities challenging for all, but particularly exempt reporting advisers that may not have written policies and procedures or a dedicated compliance person. And importantly, the legacy status granted under the final rules, discuss below, does not apply to these activities, so the restrictions are applicable to all private fund advisers. See below for more on "legacy status."

Notably, in a departure from the proposing release, the SEC followed the recommendation of its staff and did not adopt its proposed prohibition on fees for unperformed services because it believes charging such fees (including indirectly, by charging fees to a portfolio investment held by the fund) where the adviser does not, or does not reasonably expect to, provide such services already, is inconsistent with an adviser's fiduciary duty. It's not clear if disclosure alone could satisfy that fiduciary duty with respect to fees for unperformed services.[21]

The SEC also did not adopt its proposed waiver or indemnification prohibition, which as proposed, would have prohibited an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, *negligence*, or recklessness in providing services to the private fund. The SEC noted that most commenters opposed such a prohibition and that, after considering comments, an adviser's fiduciary duty to its private fund clients and the antifraud prohibitions under the Advisers Act are sufficient to address what the SEC referred to as a "problematic practice."[22] In the Adopting Release, the SEC reaffirmed and clarified its views on how an adviser's fiduciary duty applies to its private fund clients and how the antifraud provisions apply to the adviser's dealings with clients and fund investors. The SEC specifically stated that a waiver of an adviser's compliance with its Federal antifraud liability for breach of its fiduciary duty to the private fund or otherwise, or of any other provision of the Advisers Act, or rules thereunder, is invalid under the Advisers Act.

It's not clear what impact the SEC's clarifications in the adopting release will have on industry practices, particularly because the text of the adopting release, though a good indicator of how the staff will interpret a rule provisions and approach particular issues, is not itself part of the rule.

20. This prohibition will not apply with respect to contractual agreements governing a borrowing, loan, or extension of credit entered into by a private fund that has commenced operations as of the compliance date (as discussed below) and that were entered into in writing prior to the compliance date if such prohibition would require the parties to amend such governing agreements.
21. Following the adoption of the final rules, but before the compliance date, the SEC brought a Cease-And-Desist Order against American Infrastructure Funds LLC ("AIM") for charging accelerated monitoring fees. See In the Matter of American Infrastructure Funds LLC (Sept. 22, 2023) (AIM breached its fiduciary duty to private funds that it advised by failing to adequately disclose its conflict of interest in receiving accelerated monitoring fees paid by a portfolio company when that portfolio company was sold and failing to consider whether the fee acceleration was in its clients' best interest).
22. *See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance*, SEC Release No. IA-6383 at 256-258 (Aug. 23, 2023), available at: https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.

Preferential Treatment Rule – 211(h)(2)-3. *All private fund advisers — **whether registered or exempt*** — are 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 private fund adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a similar pool of assets, except: (i) if such ability to redeem is required by the 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 any similar pool of assets is subject; or (ii) if the private fund 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[23];

- Providing information regarding the portfolio holdings or exposures of the private fund, or of a similar pool of assets, to any investor in the private fund if the private fund 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, except if the private fund adviser offers such information to all other existing investors in the private fund and any similar pool of assets at the same time or substantially the same time[24];

- Providing any preferential treatment to any investor in the private fund unless the private fund adviser provides written notice as follows:
    - For prospective investors in a private fund, the private fund adviser must provide each prospective investor, prior to the investor's investment in the private fund, with a written notice that provides specific information regarding any preferential treatment related to any material economic terms that the private fund adviser or its related persons provide to other investors in the same private fund.
    - For current investors in a private fund, the private fund adviser must provide current investors with the following:
        - For an illiquid fund, as soon as reasonably practicable following the end of the private fund's fundraising period, written disclosure of all preferential treatment the private fund adviser or its related persons has provided to other investors in the same private fund;
        - For a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund, written disclosure of all preferential treatment the private fund adviser or its related persons has provided to other investors in the same private fund; and
        - On at least an annual basis, a written notice that provides specific information regarding any preferential treatment provided by the private fund adviser or its related persons to other investors in the same private fund since the last written notice.

Industry best practice is not to give preferential withdrawal or transparency rights in side letters, and to disclose the possibility of the private fund entering into side letters with certain investors to vary the terms of the private fund's governing documents with respect to that particular investor.

23. This prohibition will not apply with respect to contractual agreements governing a private fund that has commenced operations as of the compliance date (as discussed below) and that were entered into in writing prior to the compliance date if such prohibition would require the parties to amend such governing agreements.
24. It's not clear from the adopting release what facts and circumstances advisers need to consider aside from whether redemption rights are available. That being said, the SEC refused to grant a blanket exemption for closed-end funds with redemptions in extraordinary circumstances.

On August 3, 2022, the SEC settled charges against Deccan Value Investors LP for allegedly breaching its fiduciary duties by favoring non-redeeming clients and investors when handling full redemptions for two University investors.[25] Of course, there were specific facts and other alleged violations, but notably the basis of the SEC's claims was lack of disclosure, not that preferential liquidity is *per se* a breach of fiduciary duty.

However, the final rule requires advisers to make determinations as to whether preferential withdrawal and transparency rights have a material, negative effect on other investors, which may be challenging from a compliance perspective. Also, as Commissioner Pearce noted in her remarks during the open meeting, "conditioning preferential rights on offering them to everyone sounds like a ban on offering preferential rights, but the release does not characterize what we are doing as a ban."[26] The final rule also requires periodic notice of all specific side letter provisions. Notably, the final version of the rules provides "legacy status" for certain existing private funds, which exempts advisers to those funds from compliance with the Preferential Treatment Rule. See below for more on "legacy status."

Managing the preferential treatment requirements is going to be a challenge. There are a variety of restrictions and notices required. In particular, the requirements for transparency pose unique challenges because they will impact one-on-one discussions or discussions with subsets of investors. Limited partner advisory committees (LPACs) are not insulated from the challenges presented by the rules. In fact, the SEC noted in its adopting release that LPACs "may not have sufficient independence, authority, or accountability to oversee and provide investors' consent to these conflicts," as required by the rules. Managers will have to thoughtfully work through how to communicate with investors. Some advisers may reduce reliance on LPACs. Firms may also decide to stick to a script when having one-off discussions with one or a subset of investors.

Exempt Status under the Private Fund Rules

Legacy Status. The new rule includes a provision granting a limited "legacy status" for managers of certain private funds. Legacy status is available only with respect to contractual agreements governing a private fund (i) that has commenced operations as of the compliance date and that were entered into in writing prior to the compliance date, but only if (ii) the rule prohibitions on preferential liquidity and transparency would require the parties to amend such governing agreements. As far as scope, legacy status exempts qualifying investor agreements from (1) the prohibitions aspect of the Preferential Treatment Rule prohibiting advisers from providing certain preferential redemption rights and information about portfolio holdings, and (2) from the aspects of the Restricted Activities Rule that require investor consent where an adviserborrows from a private fund or charges for certain investigation fees and expenses.[27] For purposes of determining legacy status, the commencement of operations includes 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.

Securitized Asset Funds (SAFs) As noted above, SAFs are exempt from many provisions in the new rules. Securitized asset funds include any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders. The definition does not include traditional hedge funds, private equity, venture capital funds, real estate & credit funds. SAFs aren't required to follow the rules governing quarterly statements, restricted activities, adviser-led secondaries, preferential treatment, or audits. However, if advisers advise non-SAF funds, those funds would be subject to the requirements.

25. *See In the Matter of Deccan Value Investors LP and Vinit Boadas*, IA Rel. No. 6079 (August 3, 2022), available at: https://www.sec.gov/files/litigation/admin/2022/ia-6079.pdf.
26. *See* Commissioner Hester M. Peirce, Uprooted: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Aug. 23, 2023), available at: https://www.sec.gov/news/statement/peirce-statement-doc-registered-investment-adviser-compliance-reviews-08232023.
27. Legacy status does not permit advisers to charge for 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.

Amended Books and Records Rule – 204-2

All SEC-registered private fund advisers (and those required to be registered) will be required to make and keep records relating to the following:

- Any notice required pursuant to the Preferential Treatment Rule, as well as a record of each addressee and the corresponding date(s) sent;
- A copy of any quarterly statement distributed pursuant to the Quarterly Statements Rule, along with a record of each addressee and the corresponding date(s) sent, and all records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any statement delivered pursuant to the Quarterly Statements Rule;
- For each private fund client: (i) a copy of any audited financial statements prepared and distributed pursuant to the Private Fund Audit Rule, along with a record of each addressee and the corresponding date(s) sent; or (ii) a record documenting steps taken by the private fund adviser to cause a private fund client that the private fund advisor does not control, is not controlled by, and with which it is not under common control to undergo a financial statement audit pursuant to the Private Fund Audit Rule;
- Documentation substantiating the private fund adviser's determination that a private fund client is a liquid fund or an illiquid fund pursuant to the Quarterly Statements Rule;
- A copy of any fairness opinion or valuation opinion and material business relationship summary distributed pursuant to the Adviser-Led Secondaries Rule, along with a record of each addressee and the corresponding date(s) sent; and
- A copy of any notification, consent, or other document distributed or received pursuant to the Restricted Activities Rule, along with a record of each addressee and the corresponding date(s) sent for each such document distributed by the private fund adviser.

Amended Compliance Rule – 206(4)-7

The Adopting Release includes amendments to the Compliance Rule requiring *all SEC-registered advisers, **including those that do not advise private funds***, to document in writing the required annual review of their compliance policies and procedures. The SEC noted in the Adopting Release that the amendments will result in records of annual compliance reviews that allows the SEC staff to determine whether an adviser has complied with the review requirement of the Compliance Rule.[28] While most advisers already document their annual review report to management,[29] practices vary in part out of concern that such documents will increase enforcement risks associated with breaches or potential deficiencies identified. The amended Compliance Rule aligns the rule with Rule 38a-1 under the Investment Company Act of 1940, as amended, which requires registered fund CCOs to provide a written report to the registered fund's board at least annually.

Compliance Dates

The compliance date for the amended Advisers Act Compliance Rule is November 13, 2023. The compliance date for the Private Fund Audit Rule and the Quarterly Statement Rule is March 14,

28. *See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance*, SEC Release No. IA-6383 at 302 (Aug. 23, 2023), available at: https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.
29. See https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/about/190618_IMCTS_slides_after_webcast_edits.pdf. The 2019 Investment Management Compliance Testing Survey conducted by ACA Compliance and the Investment Advisers Association, show that respondents documented their annual compliance program review results as follows: 57% prepared lengthy written reports (down from 65% reported in the 2018 survey); 33% prepared short memorandum summarizing the findings; and 3% prepared informal documentation (notes).

2025. For the Adviser-Led Secondaries Rule, the Preferential Treatment Rule, and the Restricted Activities Rule, the compliance date is September 14, 2024, for large private fund advisers and March 14, 2025, for smaller fund advisers. Please see the chart attached as Attachment A for the dates of compliance.

Uncertainties

Validity of the Rules. On September 1, 2023, six industry groups filed a lawsuit in the U.S. Court of Appeals for the Fifth Circuit against the SEC challenging the new Private Fund Adviser rule, the rule is and will remain final unless and until vacated by the court.[30] It's impossible to predict the ultimate outcome of the case and whether the rule will be vacated entirely or in part, or to predict the impact, if any, on the SEC's fiduciary duty clarifications set forth in the rule's adopting release.

Use of LPACs for Governing Other Conflicts. The adopting release states that LPACs or fund boards of directors may not have sufficient independence, authority, or accountability to oversee and consent to certain conflicts between the fund and its investors, and that LPACs members

do not have a fiduciary obligation to a private fund's investors. It's not clear how this could impact industry practice of using LPACs to address certain conflicts of interest not addressed by the rules, including obtaining informed consent for principal and cross transactions as well as changes of control.

Next Steps

Do not wait to see what happens with pending litigation.

Assess the scope of the rule and start with the changes that will require the quickest action. Use the chart below to assess compliance dates for your firm. Adviser registration status will determine which parts of the rule apply.

Advisers should determine if existing funds will have legacy status regarding the certain restricted activities and preferential treatment rules based on expected subsequent closings. For advisers that intend to use existing fund documents as a template for future funds, the advisers should coordinate with fund counsel to identify provisions that are inconsistent with the rules.

Legacy status is only available for the prohibitions aspects of the Preferential Treatment Rule and the aspects of the Restricted Activities Rule requiring investor consent, and then only if amendments to the fund documents are required to comply with such rules. Notwithstanding the availability of legacy status, advisers may want to update their fund documents to include provisions that meet the requirements of the revised rules. For example, adding authority to charge certain fees or modifying procedures for engaging in restricted activities to match those paths to compliance required the under rule.

Map out and document the firm's road to implementation. SEC examiners scrutinized implementation following adoption of the Marketing Rule, and enforcement cases already have been brought based on Marketing Rule violations. If a firm is unable to produce documentation to evidence an action being taken, examiners generally assume it did not happen. To mitigate liability risk under the new Private Fund rules, advisers should consider taking the following steps:

30. Petition for Review, National Association of Private Fund Managers v. Securities and Exchange Commission, No. 23-60471 (5th Cir. filed Sept. 1, 2023).

1. *Review policies and procedures, fund documents, and Form ADV disclosures* to determine what, if any, changes are required. While some of the practices now required by the Private Funds Rules may be followed in spirit or in practice, firms will be better positioned if they update compliance policies and procedures and fund regulatory disclosure documents to expressly reflect any applicable changes required by the new rules.

2. *Conduct training* to ensure all employees are aware of the upcoming changes and plan for future fund launches, including working with legal counsel on new fund documents to use post-close.

3. *Coordinate with the firm's service providers*. Many SEC registered private fund advisers will need to make significant changes over the next 12 – 18 months. Delegate or outsource areas in which the firm does not have the time, resources, or knowledge to meet the new regulatory expectations.

    a. Fund Administrator: Fund administrators will be instrumental in meeting the quarterly statement requirements. Firms that do not utilize fund administrators should start preparing for the necessary updates as soon as possible and seek help from a fund administrator if the firm is unable to meet the requirements internally.
    b. Auditors: Firms considering secondaries for non-legacy funds post compliance date should start the selection process for auditors for any funds that do not currently receive them and fairness opinion or valuation opinion service providers for those considering secondaries.
    c. Legal counsel: Seek legal counsel to determine if any changes are necessary for future fund legal documents.
    d. Compliance: Coordinate with the firm's compliance partner to assist with making required changes to compliance policies and procedures and Form ADV disclosures.

Attachment A

Rule:	Larger Private Fund Advisers	Smaller Private Fund Advisers
211(h)(1)-2: prepare and distribute a quarterly statement to private fund investors that includes certain standardized disclosures regarding the costs of investing in the private fund and the private fund's performance	18 months after date of publication in the Federal Register **March 14, 2025**	18 months after date of publication in the Federal Register **March 14, 2025**
206(4)-10: have their private fund clients (other than a SAF client) undergo a financial statement audit that meets the requirements of the audit provision of the custody rule	18 months after date of publication in the Federal Register **March 14, 2025**	18 months after date of publication in the Federal Register **March 14, 2025**
211(h)(2)-1: restrict all private fund advisers (other than an adviser to SAFs with respect to such funds) from, directly or indirectly, engaging in certain sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors	12 months after date of publication in the Federal Register **September 14, 2024**	18 months after date of publication in the Federal Register **March 14, 2025**
211(h)(2)-2: obtain and distribute to investors in the private fund a fairness opinion or valuation opinion from an independent opinion provider and a summary of any material business relationships that the adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance date of the fairness opinion or valuation opinion, with the independent opinion provider	12 months after date of publication in the Federal Register ***September 14, 2024***	18 months after date of publication in the Federal Register **March 14, 2025**
211(h)(2)-3: prohibit a private fund adviser from (1) allowing investor to redeem interest on terms adverse to other investors and (2) providing information regarding portfolio holdings or exposures to an investor that would adversely affect other investors.	12 months after date of publication in the Federal Register **September 14, 2024**	18 months after date of publication in the Federal Register **March 14, 2025**
Rule	**All Investment Advisers**	
206(4)-7(b): require all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing	60 days after date of publication in the Federal Register **November 13, 2023**	