



## Regulatory Roundup: Rules Impacting Investment Advisers and Private Funds

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# The Rulemaking Agenda: What's the Big Picture?



## RULEMAKING IN CONTEXT

“The Securities and Exchange Commission’s job is to make markets work. But today’s SEC leadership—which as of August had proposed 26 new rules this year alone—is ignoring the real-world effects of its regulations on market participants.”

“An SEC that treats regulation as an academic exercise, in which benefits are theoretical and costs are irrelevant, is a danger to all of us.”

Eric Pan, *Wall Street Journal* Editorial, November 1, 2022



## Agency Rule List - Spring 2022

### Securities and Exchange Commission

Agency	Agenda Stage of Rulemaking	Title	RIN
SEC	Proposed Rule Stage	Corporate Board Diversity	<a href="#">3235-AL91</a>
SEC	Proposed Rule Stage	Disclosure of Payments by Resource Extraction Issuers	<a href="#">3235-AM06</a>
SEC	Proposed Rule Stage	Rule 144 Holding Period	<a href="#">3235-AM78</a>
SEC	Proposed Rule Stage	Human Capital Management Disclosure	<a href="#">3235-AM88</a>
SEC	Proposed Rule Stage	Special Purpose Acquisition Companies	<a href="#">3235-AM90</a>
SEC	Proposed Rule Stage	Rule 14a-8 Amendments	<a href="#">3235-AM91</a>
SEC	Proposed Rule Stage	Regulation D and Form D Improvements	<a href="#">3235-AN04</a>
SEC	Proposed Rule Stage	Revisions to the Definition of Securities Held of Record	<a href="#">3235-AN05</a>
SEC	Proposed Rule Stage	Amendments to the Custody Rules for Investment Advisers	<a href="#">3235-AM32</a>
SEC	Proposed Rule Stage	Amendments to Fund Names Rule	<a href="#">3235-AM72</a>
SEC	Proposed Rule Stage	Third Party Service Providers	<a href="#">3235-AM95</a>
SEC	Proposed Rule Stage	Rules Related to Investment Companies and Investment Advisers to Address Matters Relating to Environmental, Social and Governance Factors	<a href="#">3235-AM96</a>
SEC	Proposed Rule Stage	Open-End Fund Liquidity and Dilution Management	<a href="#">3235-AM98</a>
SEC	Proposed Rule Stage	Fund Fee Disclosure and Reform	<a href="#">3235-AN12</a>
SEC	Proposed Rule Stage	Amendments to Form PF	<a href="#">3235-AN13</a>
SEC	Proposed Rule Stage	Digital Engagement Practices for Investment Advisers	<a href="#">3235-AN14</a>
SEC	Proposed Rule Stage	Clearing Agency Governance	<a href="#">3235-AK74</a>
SEC	Proposed Rule Stage	Security-Based Swap Execution Facilities	<a href="#">3235-AK93</a>
SEC	Proposed Rule Stage	Prohibition Against Conflicts of Interest Relating to Certain Securitizations	<a href="#">3235-AL04</a>
SEC	Proposed Rule Stage	Exchange-Traded Products	<a href="#">3235-AL57</a>
SEC	Proposed Rule Stage	Electronic Filing of Broker-Dealer, Clearing Agency, and Self-Regulatory Organization Security-Based Swap Entity Reports	<a href="#">3235-AL85</a>
SEC	Proposed Rule Stage	Equity Market Structure Modernization	<a href="#">3235-AM57</a>
SEC	Proposed Rule Stage	Digital Engagement Practices for Broker-Dealers	<a href="#">3235-AN00</a>
SEC	Proposed Rule Stage	Expanding Clearing of Government Securities	<a href="#">3235-AN09</a>
SEC	Proposed Rule Stage	Cybersecurity	<a href="#">3235-AN15</a>
SEC	Proposed Rule Stage	Regulation ATS Modernization	<a href="#">3235-AN16</a>
SEC	Proposed Rule Stage	Narrowing Exemption for Certain Exchange Members	<a href="#">3235-AN17</a>
SEC	Final Rule Stage	Listing Standards for Recovery of Erroneously Awarded Compensation	<a href="#">3235-AK99</a>
SEC	Final Rule Stage	Pay Versus Performance	<a href="#">3235-AL00</a>
SEC	Final Rule Stage	Mandated Electronic Filings	<a href="#">3235-AM15</a>
SEC	Final Rule Stage	Rule 10b5-1 and Insider Trading	<a href="#">3235-AM86</a>
SEC	Final Rule Stage	Climate Change Disclosure	<a href="#">3235-AM87</a>
SEC	Final Rule Stage	Cybersecurity Risk Governance	<a href="#">3235-AM89</a>
SEC	Final Rule Stage	Proxy Voting Advice	<a href="#">3235-AM92</a>
SEC	Final Rule Stage	Modernization of Beneficial Ownership Reporting	<a href="#">3235-AM93</a>
SEC	Final Rule Stage	Share Repurchase Disclosure Modernization	<a href="#">3235-AM94</a>
SEC	Final Rule Stage	Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting on Executive Compensation Votes by Institutional Investment Managers	<a href="#">3235-AK87</a>
SEC	Final Rule Stage	Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and ETFs; Fee Information in Investment Company Ads	<a href="#">3235-AM52</a>
SEC	Final Rule Stage	Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers	<a href="#">3235-AM75</a>
SEC	Final Rule Stage	Money Market Fund Reforms	<a href="#">3235-AM80</a>
SEC	Final Rule Stage	Electronic Submission of Applications for Orders Under the Advisers Act, Confidential Treatment Requests for Filings on Form 13F, and ADV-NR	<a href="#">3235-AM97</a>
SEC	Final Rule Stage	Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews	<a href="#">3235-AN07</a>
SEC	Final Rule Stage	Cybersecurity Risk Governance	<a href="#">3235-AN08</a>
SEC	Final Rule Stage	Prohibition Against Fraud, Manipulation, and Deception in Connection With Security-Based Swaps; Prohibition Against Undue Influence Over Chief Compliance Officers; and Disclosure of SBS Positions	<a href="#">3235-AK77</a>
SEC	Final Rule Stage	Removal of References to Credit Ratings From Regulation M	<a href="#">3235-AL14</a>
SEC	Final Rule Stage	Short Sale Disclosure Reforms	<a href="#">3235-AM34</a>
SEC	Final Rule Stage	Amendments to Exchange Act Rule 3b-16 re Definition of "Exchange"; Regulation ATS and Regulation SCI for ATSs That Trade U.S. Government Securities, NMS Stocks and Other Securities	<a href="#">3235-AM45</a>
SEC	Final Rule Stage	Amendments to NMS Plan for the Consolidated Audit Trail Data Security	<a href="#">3235-AM62</a>
SEC	Final Rule Stage	Electronic Recordkeeping Requirements for Broker-Dealers and Security-Based Swap Dealers and Major Security-Based Swap Participants	<a href="#">3235-AM76</a>
SEC	Final Rule Stage	Loan or Borrowing of Securities	<a href="#">3235-AN01</a>
SEC	Final Rule Stage	Amendments to Securities Transaction Settlement Cycle	<a href="#">3235-AN02</a>
SEC	Final Rule Stage	Further Definition of Dealers	<a href="#">3235-AN10</a>
SEC	Final Rule Stage	Amendments to the Commission's Whistleblower Program Rules	<a href="#">3235-AN03</a>



# THE MARKETING RULE

- Proposed on December 22, 2020; **Effective Date: November 4, 2022**
- The new “Marketing Rule” under the Investment Advisers Act of 1940 (the “Advisers Act”) creates a single rule that replaces:
  - Rule 206(4)-3 under the Advisers Rule (the “Solicitation Rule”); and
  - Rule 206(4)-1 under the Advisers Act (the “Advertising Rule”)
- The Marketing Rule represents the first substantive amendments to the Solicitation Rule since its adoption in 1979.
- In connection with the implementation of the Marketing Rule, the SEC withdrew dozens of no-action letters interpreting the existing Solicitation and Advertising Rules.



# THE MARKETING RULE

- **The Marketing Rule extends to all “private funds”**
- The Rule establishes standardized, rule-based framework for performance advertising
- Performance is Explicitly addresses performance portability and extracted performance
- Replaces *per se* prohibitions with principles-based standards
- Expressly permits past specific recommendations, testimonials, and third-party ratings
- Guidance on social media, layered disclosures



# PRIVATE FUND ADVISERS RULE

- Proposed on February 9, 2022
  - If enacted, creates significant new disclosure, operational, and other regulatory obligations for advisers to private funds
- Key Aspects of the New Requirements for Registered Advisers:
  - Provide investors with quarterly statements detailing information about private fund performance, fees, and expenses;
  - Obtain an annual audit performed by an independent public accountant for each private fund and cause the auditor to notify the SEC upon certain events; and
  - In connection with an adviser-led secondary transaction, distribute to investors a
    - (1) fairness opinion from an independent party as to the consideration proposed to be received by private fund; and
    - (2) a written summary of certain material business relationships between the adviser and the opinion provider.



# PRIVATE FUND ADVISERS RULE

- Key Aspects of the New Requirements and Prohibitions for ALL advisers to private funds, *including Non-Registered Advisers*:
  - Prohibitions on
    - (i) charging certain fees and expenses to a private fund or its portfolio investments, such as fees for unperformed services, or fees associated with an SEC examination or investigation of the adviser;
    - (ii) seeking reimbursement, indemnification, exculpation, or limitation of its liability for certain activities;
    - (iii) determining the GP clawback on an after-tax basis;
    - (iv) charging fees or expenses related to a portfolio investment on a non-pro rata basis; and
    - (v) borrowing or receiving an extension of credit from a private fund client; and
  - Prohibition on providing certain types of preferential treatment in connection with redemptions from the private fund or portfolio information, and prohibiting other types of preferential treatment absent disclosure.



# CYBERSECURITY RISK GOVERNANCE

- Proposed on February 9, 2022
- **Policies and Procedures.** Advisers (and registered funds) must adopt and implement written policies and procedures, including specific enumerated elements, reasonably designed to address cybersecurity risks
  - As proposed, “cybersecurity risk” is defined as the “financial, operational, legal, reputational, and other adverse consequences that could stem from cybersecurity incidents, threats, and vulnerabilities”
- **Reporting.** Advisers to report certain cybersecurity incidents to the SEC on new Form ADV-C within 48 hours, including on behalf of any registered funds or private funds that experience such incidents
- **Disclosure.** Advisers and registered funds to disclose cybersecurity risks and incidents in their disclosure documents



# ENHANCED ESG DISCLOSURES

- Proposed on May 25, 2022
- **Would apply to registered *and* unregistered advisers**
- Proposed new **Part 2A (Brochure)** disclosures include descriptions of:
  - **Strategy** - ESG factors considered for each “significant” investment strategy or method of analysis, including whether and how the adviser incorporates a particular factor or combination thereof
    - If an adviser considers different ESG factors for different strategies, separate disclosures would be required for each.
  - **Criteria** - Any criteria or methodology used to evaluate, select, or exclude investments based on the consideration of ESG factors, including any:
    - internal methodology or third-party framework,
    - inclusionary or exclusionary screen
    - Any index utilized including the name and a description of how the index utilizes ESG factors
  - **Relationships with Related Persons** – Any material relationship or arrangement with any related person that is an “ESG consultant” or other service provider.
  - **Proxy Voting** - For an adviser that has specific proxy voting policies and procedures to include one or more ESG considerations when voting client securities, a description of the ESG factors that are considered and how they are considered.



# ENHANCED ESG DISCLOSURES

- **Advisers Sponsoring Wrap Fee Programs** – Would require disclosure regarding ESG factors considered in the selection, review, or recommendation of the PM or affirmative statement that do not assess the PM’s application of ESG factors.
- **Proposed new Form ADV Part 1A requirements** include:
  - Advisers managing **separately managed accounts** would be required to disclose:
    - Whether they “consider” ESG factors when managing such accounts
      - Advisers would be required to report if they use an **integration, ESG-focused or impact strategy** and the specific factors considered (i.e., environmental, social, and/or governance).
    - Whether they follow any third-party ESG frameworks (e.g., UN PRI) in connection with their advisory services, and identify any such frameworks.
  - **Advisers of private funds** would be required to disclose:
    - Information about the use of ESG factors in managing each reported private fund, including the type of strategy and specific factors considered.
    - Whether the adviser conducts other business activities as, or has related persons that are, ESG consultants or other ESG service providers.



# ADDITIONAL AMENDMENTS TO FORM PF

- Proposed on August 10, 2022
  - The additional amendments to Form PF, proposed by the SEC and CFTC, supplements portions of Form PF proposed by the SEC in January 2022. Neither the January or August proposed amendments have been adopted by the SEC.
- Key Aspects of the Proposal
  - Requires private fund advisers to report more granular information regarding a reporting fund's investment strategies, counterparty exposure, operations, assets, financing, investor concentration, and performance, among other things.
  - Taken together, the proposed amendments would, if adopted, represent a significant shift in the depth of information required to be reported by private fund advisers on Form PF, as well as the timeline for reporting such information.
- SEC proposals seek to enhance disclosure and oversight in the industry
- Public comment period for the August proposal expired on October 11, 2022



# SERVICE PROVIDER OVERSIGHT

- Proposed on October 26, 2022
- Key Aspects of Proposal
  - **Outsourcing “Covered Functions”** Proposed Rule 206(4)-11 would prohibit SEC-registered investment advisers from outsourcing certain “covered functions” to service providers unless certain requirements are met
  - **Definition of “Covered Functions”** Functions or services that:
    - (1) are necessary to provide advisory services in compliance with the federal securities laws; and
    - (2) if not performed or performed negligently, would reasonably be likely to cause a material negative impact on the adviser’s clients or on the adviser’s ability to provide investment advisory services.



## SERVICE PROVIDER OVERSIGHT

- Key Aspects of Proposal, continued
  - **Due Diligence.** Before retaining a service provider to perform a “covered function,” reasonably identify and determine through due diligence that outsourcing would be appropriate.
  - **Monitoring.** Adviser would be required to monitor performance and reassess the selection of the service provider. Adviser would also be required to create and maintain books and records relating to its due diligence and monitoring activities.
  - **Oversight of Third Party Recordkeepers.** Advisers that rely on third-party recordkeepers must conduct due diligence and monitoring of that third party as if the third party were a “service provider” performing a “covered function” as defined by the proposed rule.





# Implementation Process



# MARKETING RULE TIMELINE

November 4, 2019

Initial Rule  
Proposal

December 22, 2022

SEC  
Adoption

March 5, 2021

Publication  
in Federal  
Register

May 4, 2021

Effective  
Date

November 4, 2022

Compliance  
Date

**Exactly 36 months from proposal to adoption**



# MARKETING RULE IMPLEMENTATION PROCESS

September 2022 Alert:

“The staff will conduct a number of specific national initiatives, as well as a ***broad review through the examination process*** for compliance with the Marketing Rule” that will include, but will not be limited to, the following areas:

- Marketing Rule Policies and Procedures
- Substantiation Requirement
- Performance Advertising Requirements
- Books and Records

“The Division encourages advisers to ... implement any appropriate modifications to their **training, supervisory, oversight, and compliance programs.**”





# THE SEC'S PROPOSED PRIVATE FUND ADVISER RULES



## STATED PURPOSES FOR PROPOSAL

- Prohibit particular practices that SEC believes present conflicts of interest that cannot be solved by any level of disclosure (and resulting informed consent)
- Provide investors greater transparency
- Correct perceived asymmetry of bargaining power between advisers and investors (even large, sophisticated investors) and between smaller and larger investors



## LIKELY EFFECTS OF PROPOSED RULES

- Greatly expanded regulatory compliance obligations for advisers to private funds
- Extensions of types of protections formerly reserved to retail investors in public vehicles to sophisticated investors in private vehicles
- Substantial revision of (and, in some cases, renegotiation of) existing funds and agreed documentation as well as changes to future funds



## PROHIBITED ACTIVITIES

- Currently, private fund advisers can address most conflicts through **full and fair disclosure** of, and **informed consent** to, the conflict
- Proposed rule would **flatly prohibit** certain perceived conflicts of interest, as determined by the SEC *ex ante*, regardless of adviser's registration status or sophistication of investor counterparties



# EXAMPLES OF PROHIBITED ACTIVITIES

- No preferential liquidity **and information** terms via side letter; required notice to other investors **and potential investors** of “other preferential terms”
- No exculpation for adviser’s failure to meet negligence standard of care in providing services to a private fund (as opposed to typical gross negligence)
- No non-pro rata expense allocations for “broken deals.” Must allocate expenses to parties who are not fund investors and never invest in a deal
- Cannot charge private funds for advisers’ regulatory and compliance fees and expenses (including those associated with examination or investigation)
- No charging for underperformed/unperformed services



# INVESTOR TRANSPARENCY

- Requires **registered** advisers to (i) provide quarterly statement to private fund investors with detailed accounting of both **fund-** and **portfolio company-level** information, and (ii) obtain an annual audit of each private fund by an independent public accountant subject to PCAOB oversight
- Stated purpose to **reduce** investor expense and burden associated with monitoring expenses, performance, and conflicting arrangements, and **improve** investors' ability to negotiate fund terms and compare services provided by advisers and other service providers
- Although requirements are generally (but not wholly) consistent with typical existing practice and rules, mandated timelines are tighter, more detail is required, and fewer exceptions are permitted than in existing regimes



## ADDITIONAL POINTS RE TRANSPARENCY

- Quarterly reports must present performance information using SEC-mandated calculations (without regard for leverage provided through subscription facilities), with prominent disclosure of criteria used and assumptions made when calculating performance
- Subadvisers must take “all reasonable steps” to require compliance with audit requirement for each private fund they subadvise, even if the private fund is controlled by an unaffiliated adviser and the subadviser does not have custody of the private fund’s investments
- Private fund’s auditor must notify the SEC if the auditor is terminated or modifies its audit opinion



# ADVISER-LED SECONDARIES

- For certain adviser-led secondary transactions, **registered** advisers must obtain and distribute prior to close (i) a fairness opinion provided by a third-party opinion provider and (ii) a summary of the material business relationships between opinion provider and adviser or related persons
- Covers transactions that the private fund adviser or its related persons initiate and that offer investors the option either to sell their interests or to convert or exchange their interests for interests in another vehicle that the private fund adviser or its related persons advise
- Provider of fairness opinion must be unrelated third party that provides such opinions in the ordinary course of business





# Digital Assets



## CURRENT LANDSCAPE

- Crypto Winter: The market cap of the largest 100 cryptocurrencies fell 62% year-over-year in 2021-2022
- But institutional and investment interest in these assets remains strong.
- A number of large financial institutions have reported that, despite the market downturn, institutional investors still express interest in their digital asset offerings, and some institutions have announced the development of digital asset trading platforms
- Still, because some believe that the market downturn was caused by lack of oversight and unmitigated enthusiasm, limited partners are imposing tighter compliance and security standards for funds and separately managed accounts backing digital asset products and crypto-related companies



# KEY CONSIDERATIONS FOR ASSET MANAGERS

- Bitcoin ETFs?
- Updated Form PF for Hedge Funds
- Valuation Concerns
- Fiduciary Duty / Code of Ethics
- Custody of Digital Assets
- Jurisdictional Questions



## EXCHANGE TRADED FUNDS

- To date, the SEC has only approved Bitcoin futures ETFs, while rejecting “physically-backed” or spot crypto ETFs
  - Proshares successfully launched a Bitcoin Futures ETF in 2021, allowing traditional investors to gain exposure to bitcoin
- The SEC views futures trading on a regulated U.S. exchange more favorably than other crypto-related investments
- Grayscale filed to convert its Bitcoin Trust into a spot Bitcoin ETF, which the SEC denied, citing other spot-bitcoin ETFs whose petitions the SEC had previously denied
- In August 2022, Grayscale filed a petition for review with the DC Court of Appeals, and the SEC’s response is due in December 2022



## HEDGE FUNDS AND FORM PF

- The SEC has proposed that large hedge funds may need to disclose digital asset holdings through Form PF, a form that the SEC uses to evaluate market-wide risk
- The regulator's concern was that volatility in digital asset holdings by large private funds could create a chain reaction when digital asset prices dip
- Regulators want to avoid another Three Arrows Capital, whose default on a \$670 million loan led to the bankruptcy of Voyager Digital, a digital asset exchange, and Celsius, a digital asset lending platform
- The comment period for this proposal ended on October 11, 2022



# VALUATION

- In 2021, the SEC observed in a Risk Alert that investment advisers may face valuation challenges for digital assets due to market fragmentation, illiquidity, volatility, and the potential for manipulation.
- Advisers should review their valuation methodologies with respect to any digital assets held in client accounts, and at a minimum, should ensure that:
  - They can identify and monitor for events that could impact the valuation of digital assets held in client accounts (e.g., “airdrops” and forks).
  - Their fair valuation procedures are up to date, and confirm there are appropriate means of determining price inputs.



# FIDUCIARY DUTY / CODE OF ETHICS

- The Advisers Act reflects a congressional intent to at least expose, if not eliminate, all conflicts of interest that could incite an investment adviser to provide advice that is not disinterested
- The 1940 Act imposes additional substantive obligations and restrictions on investment advisers and their affiliates to refrain from self-dealing
- The SEC issued an interpretive release in June 2019 stating that an adviser's fiduciary duty to clients includes a duty of loyalty
  - This duty means the adviser must “eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict”
- Key Takeaway: Before recommending digital assets to clients, investment advisers must ensure they are satisfying their fiduciary duties to them
  - This requires close attention to issues such as valuation, best execution, code of ethics and personal trading



# CUSTODY

- Rule 206(4)-2 under the Advisers Act (the Custody Rule), adopted in 1962, provides that an investment adviser has “custody” of client assets if it holds, directly or indirectly, client “funds” or “securities”
  - An adviser may gain custody of client assets inadvertently, such as by being authorized by a custodial agreement to withdraw client funds or securities or, in connection with digital assets, where an adviser has access to a client’s private key to a digital asset
- The nature of digital assets and the reliance on distributed ledger technology makes the application to digital assets uncertain
- Advisers should carefully evaluate its authority with respect to customer digital assets (e.g., standing letter of instruction)
- An adviser that has determined it has custody of its clients’ digital assets and that such assets are funds or securities must hold such assets with a qualified custodian, which is a facts and circumstances based analysis



# SEC CHAIR GENSLER

“We just don’t have enough investor protection in crypto. Frankly, at this time, it’s more like the Wild West...”

“I would like this field to be inside the investor protection perimeter...I'd also like to ask this profession, people listening, to remember you have a greater responsibility than helping some folks sort of take money out of the public's pocket and try to avoid being underneath these broad laws.”



# CFTC CHAIR BEHNAM



"I think it's important for this committee [on Agriculture] to...consider expanding authority for the CFTC"

"It's critically important to have a primary cop on the beat...And certainly the CFTC is prepared to do that, if this committee [on Agriculture] so wishes."



# The future of digital asset regulation

Despite significant uncertainty on how they are regulated, digital assets are subject to the greatest level of regulatory scrutiny at present.

There are multiple legislative proposals being considered in Congress that could create a new regulatory framework for digital assets

President Biden issued an Executive Order charging regulators to identify implications of digital assets on the U.S. financial system

