K&L GATES

THE SEC'S NEW PRIVATE FUND ADVISER RULES:

A GUIDE TO COMPLIANCE

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EXECUTIVE SUMMARY

On 23 August 2023, the US Securities and Exchange Commission (the SEC) adopted a new set of private fund adviser rules (each a Rule and, collectively, the Rules, and the related release, the Adopting Release)[1] that materially increase the regulatory burden placed on investment advisers to private funds[2] under the Investment Advisers Act of 1940, as amended (the Advisers Act), while also providing new rights to investors. While not as extensive as the rule package originally proposed by the SEC in February 2022 (the Proposal),[3] the Rules will nevertheless have a significant impact on private fund advisers, the investors in their funds and the private funds industry as a whole.[4] We expect the Rules' disclosure- and consent-based framework and audit and quarterly reporting requirements will both expand the scope of and add to the substantial regulatory burden faced by advisers to private funds and, together with other rulemaking affecting private fund sponsors (e.g., the Marketing Rule,[5] Form PF Amendments,[6] and the proposed Safeguarding Rule[7]), act as the most significant change in private fund regulation since the Dodd-Frank Act mandated the registration of most private fund advisers in 2010. Compared to recent rulemaking activities, the Rules are more expansive in scope and apply to SEC-registered, exempted, and nonregistered advisers.

Many investors—particularly investors without significant negotiation leverage when facing large private fund managers—may welcome the additional disclosure and consent rights provided by the new Rules, as well as the additional information (such as detailed quarterly statements) the Rules entitle them to receive going forward. However, investors and advisers alike may find that, counterintuitively, the sunlight afforded by the Rules effectively *chills* their relations.

The Rules dramatically change certain hallmarks of the private fund space, with regulatory restrictions imposed on the sorts of terms private fund industry participants are able to negotiate, their pathways of communication, and the information they are entitled (or required) to share or receive. The recalibration of adviser-investor interactions that will likely follow may prove to be the most enduring impact of the Rules. And, while the Rules allow for grandfathering of certain existing private fund arrangements, the Rules still impose a number of new operational and compliance obligations on investment advisers, including requirements to provide very prescriptive quarterly reports. Certain of the Rules also apply only to investment advisers registered with the SEC (Registered Investment Advisers, or RIAs), while others apply to both RIAs and private fund advisers that are exempt from registration. All RIAs (including those that do not advise private funds) will also be required to comply with the Rules' mandates on compliance reviews.[8] Consequently, all investment advisers will need to familiarize themselves with the Rules to ensure compliance in advance of the SEC's implementation deadlines.

This guide contains a detailed summary of the Rules, along with practical considerations for both advisers and investors relating to compliance and implementation. In Part 1: Scope of the Private Fund Adviser Rules, we have detailed the applicability of the Rules to the different types of investment advisers and funds. In Parts 2, 3, and 4, we have outlined how the Rules apply to all private fund advisers, registered private fund advisers, and all RIAs, respectively. A reference chart summarizing implementation deadlines for each of the Rules can be found in Part 5: Key Dates for Implementation.

Please reach out to your K&L Gates private funds team with any questions (a selection of team contact information can be found at the end of the guide).

PART 1: SCOPE OF THE NEW PRIVATE FUND ADVISER RULES

The applicability of each Rule will depend on what types of funds an adviser advises, its registration status, its geographic location, and other factors. We explore the applicability of the Rules to the different types of advisers in Part 1, Section A: Applicability to Different Types of Advisers and to the different types of funds in Part 1, Section B: Applicability to Different Types of Funds, below. A reference chart summarizing the applicability of each Rule to the different types of advisers can also be found below; see ***Table 1*** below.

Additionally, the timeline in which advisers will need to implement the Rules will depend on whether an adviser is a "small adviser" or a "large adviser;" see Part 5: Key Dates for Implementation for further details.

A. APPLICABILITY TO DIFFERENT TYPES OF ADVISERS

While reviewing the applicability of the Rules to different types of advisers, advisers should bear in mind that, in each instance, the Rules are equally applicable to their related persons. The SEC defines a "related person" as (1) all officers, partners, or directors (or any person performing similar functions) of the adviser; (2) all persons directly or indirectly controlling or controlled by the adviser; (3) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (4) any person under common control with the adviser.[9] The Rules are consequently equally applicable to advisers and to those separate entities formed by an adviser in connection with a specific fund, such as the general partner or an affiliated management company.

A reference chart summarizing the applicability of the Rules can be found at the end of this Part 1.

I. Non-US Fund Advisers

In the Adopting Release, the SEC emphasized that they do not apply substantive provisions of the Advisers Act and the rules promulgated thereunder—which would include the Rules—to the non-United States (non-US) clients of SEC-registered investment advisers whose principal office and place of business is outside of the United States (i.e., "offshore advisers"). The SEC additionally clarified that the Preferential Treatment Rule and the Restricted Activities Rule (as each term is defined below)[10] will generally not apply to offshore advisers with respect to their offshore funds, regardless of whether the advisers are RIAs or if such offshore funds have United States (US) investors.

However, as discussed further in "Similar Pools of Assets," below, if an offshore fund operates in a parallel fund structure with a US-based fund, or is a feeder fund in a master-feeder structure with a US-based private fund, then the adviser to such fund will need to carefully consider the redemption, information and other preferential treatment rights granted to investors in the offshore fund, as investors in such an offshore fund will be entitled to the same treatment as investors in the onshore fund(s) if such offshore fund is deemed a "similar pool of assets" to the onshore fund(s).[11]

Registered offshore investment advisers advising only offshore funds will consequently need to comply only with the Compliance Rule[12] amendments. Unregistered offshore investment advisers advising only offshore funds are not subject to any of the Rules.

Practical Considerations

Potential Extraterritorial Effect

The above clarifications were helpful for many offshore advisers that were uncertain as to the application of the Rules, as proposed in 2022. However, while not technically applicable to the non-US clients of registered offshore advisers, we expect that there will be an extraterritorial effect of these Rules going forward as investors come to expect private fund documents—irrespective of jurisdiction—to include certain of the substantive provisions of these Rules. Non-US advisers would consequently be well-advised to familiarize themselves with the requirements of the Rules nevertheless, particularly those Rules concerning which terms can and cannot be granted to investors, going forward (see Part 2: Rules Applicable to All Private Fund Advisers).

Jurisdictions of Funds

As registered offshore advisers are generally subject to lower regulatory (and other) burdens with respect to their offshore funds, the additional compliance burdens of the Rules may result in such advisers increasingly domiciling their US-targeted funds in offshore jurisdictions such as the Cayman Islands or British Virgin Islands, despite the increased financial costs associated with forming and operating funds in such jurisdictions.

II. Registered Investment Advisers

All RIAs will be required to comply with the new amendments to the Compliance Rule (as discussed further in Part 4: Rules Applicable to All Registered Investment Advisers, below).

Whether an RIA needs to comply with the other Rules[13] will depend on whether it is advising private funds, whether the RIA is US-based, as well as where its funds are located. All RIAs to "private funds"[14] will need to comply with the Compliance Rule amendments and *all* of the other Rules, with respect to private funds they advise that are based in the United States (as well as any offshore fund that is a "similar pool of assets" of any such US private fund, in which case, certain parts of the Preferential Treatment Rule will apply to such funds). However, the compliance requirements for certain Rules will vary, depending on whether such advisers are advising liquid or illiquid private funds.[15]

RIAs that are based in the United States or that are advising US private funds will consequently need to familiarize themselves with all of the Rules.

III. Unregistered Advisers (Including ERAs, Foreign Private Advisers, and State-Registered Advisers)

With the exception of offshore advisers advising offshore private funds (as discussed in *Section I. Non-US Advisers*, above), two of the Rules, the Preferential Treatment Rule and Restricted Activities Rule, apply to *all* investment advisers to private funds, regardless of whether they are RIAs. This includes those advisers who qualify as "exempt reporting advisers" (ERAs) for purposes of the Advisers Act, including "private fund advisers" and "venture capital fund advisers."[16]

However, advisers that are excluded from the definition of "investment adviser" under the Advisers Act pursuant to section 202(a)(11) thereof are not required to comply with the Rules. Examples of such non-"investment adviser" advisers include banks and bank holding companies, government securities advisers, and certain real estate fund managers and single-family offices.[17] Because such advisers are technically not deemed to be investment advisers, they are exempted from compliance with the Rules, even if such advisers, in practice, advise private funds.

All other investment advisers exempted from registration with the SEC pursuant to section 203(b) of the Advisers Act, including "foreign private advisers"[18] and investment advisers registered only at the state (versus federal) level, must comply with the Preferential Treatment Rule and Restricted Activities Rule, to the extent they advise US private funds.[19]

B. APPLICABILITY TO DIFFERENT TYPES OF FUNDS

I. Private Funds, Generally

Private Funds

The Adopting Release explains that private funds are "privately offered investment vehicles that pool capital from one or more investors and invest in securities and other instruments or investments."[20] The SEC further clarifies that private funds are those issuers that would be investment companies but for section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the Investment Company Act).[21] All such funds consequently fall under the purview of the Rules, except as outlined in *Section II. Specific Exceptions*, below.

Qualifying Private Funds

As discussed above, while it is clear that the Rules apply to "private funds," as such term is defined in the Advisers Act, [22] a complication arises in determining the applicability of the Rules to certain other funds, specifically for funds managed by those advisers who rely on the definition of "qualifying private funds" in order to meet the requirements of the "private fund adviser" exemption from registration under the Advisers Act. Investment advisers relying on the private fund adviser exemption must (i) manage private fund assets of less than US$150 million and (ii) advise solely one or more "qualifying private funds."[23] A qualifying private fund (as such term is defined in the Advisers Act) [24] includes an issuer that qualifies for exclusion from the definition of an "investment company" under the Investment Company Act[25] pursuant to any provision of section 3 thereunder, if such issuer also meets the requirements of sections 3(c)(1) and/or 3(c)(7). For example, advising a fund offered pursuant to section 3(c)(5) of the Investment Company Act (i.e., a so-called "real estate fund") will not disqualify an adviser from relying on the private fund adviser exemption, so long as such fund also qualifies for exclusion from the Investment Company Act pursuant to sections 3(c)(1) and/or 3(c)(7). However, if an adviser elects to treat such an issuer as a qualifying private fund, in order to take advantage of the private fund adviser exemption under the Advisers Act, the adviser must treat the issuer as a private fund for *all* purposes under the Advisers Act. As such, any such qualifying private fund will be subject to the Rules.

Similar Pools of Assets

Portions of the Preferential Treatment Rule that relate to redemption rights and information rights make reference—and apply equally—to those entities which qualify as "similar pool[s] of assets" of a private fund. For purposes of the Rules, a “similar pool of assets” is a pooled investment vehicle (other than an investment company registered under the Investment Company Act or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of a private fund managed by an adviser or its related persons.[26] Consequently, entities that would not strictly be considered “private funds” under the SEC’s definition of such[27] may be captured by—and subject to—the Rules, for those advisers who manage private funds.

Notably, the SEC intended for its definition of a “similar pool of assets” to capture most common private fund structures, including master-feeder and parallel structures.[28] Therefore, if an adviser provides investment advice to a US-based private fund that has an offshore feeder fund, master fund or parallel fund, it will need to ensure that the investors in the offshore fund are offered the same redemption rights, and receive the same information regarding the private fund’s portfolio, as the investors in the onshore vehicle, and vice versa.

The SEC emphasized in its Adopting Release that what will constitute a similar pool of assets or “substantially similar pool of assets” for purposes of the Rules will be a facts and circumstances determination.[29] Factors that will be determinative of whether a pool of assets is “similar” to a private fund would include having similar investment policies, objectives, or strategies. Consequently, the SEC posited that it is unlikely that pools of assets with materially different target returns or sector focuses would be deemed “similar,” but factors like different entity types (e.g., one pool being a limited liability company and the other a limited partnership) or different base currencies would not be enough to differentiate pools (and allow them to escape the purview of the Rules).

The SEC also made a point to emphasize that the definition of a “similar pool of assets” for purposes of the Rules is broader and intended to capture more entities than analogous terms used in other recent regulation, such as the concept of a “related portfolio” within the Marketing Rule, where a pool of assets would have to have “substantially similar investment policies, objectives, *and* [emphasis added] strategies” (versus the “or” of the Rules).[30] In its Adopting Release, the SEC provided the example that an adviser’s health care-focused private fund could be deemed a similar pool of assets to that adviser’s technology-focused private fund. While potentially not being considered “substantially similar” under previous conceptions, such vehicles could nonetheless be captured by the new, broader definition of similar pools of assets under the Rules, and be treated as such for all purposes thereunder.[31]

Other Funds Excluded From Registration Under the Investment Company Act (Including Certain Real Estate Funds)

Except as discussed above, if a fund relies on an exclusion from the definition of an “investment company” under the Investment Company Act other than the exclusions set forth in sections 3(c)(1) and 3(c)(7), then such fund will not be treated as a “private fund” for purposes of the Rules. For example, a real estate fund that relies on the exclusion set forth in section 3(c)(5) of the Investment Company Act (so as not to be treated as an investment company thereunder) will not be deemed a “private fund” under the Rules. Similarly, if a collective investment trust is not deemed an investment company under the Investment Company Act pursuant to the exclusion set forth in section 3(c)(11) thereof, then it will not be treated as a “private fund” under the Rules.

However, as discussed above, advisers relying on the “private fund adviser” exemption from registration as an investment adviser under the Advisers Act will need to be careful that their non-3(c)(1) or non-3(c)(7) funds are not treated as de facto 3(c)(1) or 3(c)(7) funds (and therefore as private funds under the Rules), pursuant to the Advisers Act definition of “qualifying private funds.”[32]

II. Specific Exceptions

Securitized Asset Funds

The Rules do not apply to investment advisers with respect to securitized asset funds (SAFs). SAFs are also excluded from the definition of “similar pool[s] of assets,” and consequently will not be captured by the Rules, even if they have substantially similar investment policies, objectives, or strategies to an adviser’s private fund(s).[33]

However, not all funds reported as SAFs in an adviser’s Form ADV will be captured by this exception.[34] For purposes of the Rules, SAFs are defined as “any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt holders.”[35] For example, SAFs would include collateralized loan obligations, which consequently will not fall within the purview of the Rules. However, the SEC noted in the Adopting Release that whether certain funds will meet the Rules’ definition of an SAF will be a facts and circumstances determination. For example, the SEC noted that many rated note funds will not be deemed SAFs under the Rules, as they generally do not issue asset-backed securities.[36]

In the Adopting Release, the SEC explained that SAFs have certain distinguishing structural and operational features that deter SAF advisers from engaging in the type of conduct that the Rule attempts to address.[37] Moreover, the SEC noted that the advisory relationship between SAF advisers and their clients presents different regulatory issues than the advisory relationships addressed by the Rule.[38] The carve-outs for securitized asset funds from the final rules will be widely welcomed by the advisers of such funds. As several commentators to the Proposal indicated, the structure of such vehicles means that the application of the Rules as originally proposed would have likely been technically difficult.

Offshore Funds

As discussed in *Section I. Non-US Fund Advisers* in Part A, above, both registered and unregistered offshore advisers will not need to comply with Rules with respect to their offshore funds, regardless of the fund-type or whether the fund has non-US investors, unless such fund is a “similar pool of assets” of a US private fund, in which case, certain parts of the Preferential Treatment Rule will apply to such funds.

However, both registered and unregistered US-based advisers will need to comply with the Rules, as applicable, with respect to their offshore private fund clients.

A reference chart summarizing the applicability of the Rules to different types of investment advisers can be found below.

Table 1. *Applicability of the Rules to the Different Types of Investment Advisers.*

Rule	Applicable to Each Type of Adviser:					
	Exempt Reporting Advisers		Foreign Private Advisers? [iii]	All Other Unregistered Investment Advisers to Private Funds?	Registered Investment Advisers to Private Funds? [vi]	All Other Registered Investment Advisers? [viii]
	Private Fund Advisers? [i]	Venture Capital Fund Advisers? [ii]				
Preferential Treatment Rule	Yes	Yes	Yes [iv]	Yes [v]	Yes [vii]	N/A
Restricted Activities Rule	Yes	Yes	Yes [iv]	Yes [v]	Yes [vii]	N/A
Quarterly Statement Rule	No	No	No	No	Yes	N/A
Private Fund Audit Rule	No	No	No	No	Yes	N/A
Adviser-Led Secondaries Rule	No	No	No	No	Yes	N/A
Compliance Rule Amendments	N/A [ix]	N/A [ix]	N/A [ix]	N/A [ix]	Yes	Yes

[i] Investment advisers relying on Rule 203(m)-1 under the Advisers Act, by which advisers are exempted from registration with the SEC as an investment adviser if they act solely as adviser to one or more "qualifying private funds" (as such term is defined in Rule 203(m)-1(d)(5) of the Advisers Act) and manages private fund assets of less than $150 million.

[ii] Investment advisers relying on Rule 203(*l*)-1 under the Advisers Act, by which advisers are exempted from registration with the SEC as an investment adviser if they act solely as an adviser to one or more "venture capital funds" (as such term is defined in Rule 203(*l*)-1(a) of the Advisers Act).

[iii] Investment advisers relying on Rule 203(b)(3) under the Advisers Act, by which advisers are exempted from registration with the SEC as an investment adviser if they are "foreign private advisers" (as such term is outlined in Rule 202(a)(30)-1 of the Advisers Act).

[iv] Advisers relying on the "foreign private adviser" exemption must comply with the Preferential Treatment Rule and Restricted Activities Rules, except with respect to their offshore funds (regardless of whether those offshore funds have US investors), unless such a fund is a "similar pool of assets" of a US private fund. See Adopting Release, page 49.

[v] Unregistered offshore advisers are not required to comply with the Preferential Treatment Rule and Restricted Activities Rule with respect to their offshore funds (including those offshore funds with US investors), unless such a fund is a "similar pool of assets" of a US private fund, in which case, certain parts of the Preferential Treatment Rule will apply to such funds. See Adopting Release, page 49.

[vi] Investment advisers registered with the SEC pursuant to the Advisers Act who advise private funds, as such term is defined in the Adopting Release (i.e., any issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act).

[vii] Registered offshore advisers are not required to comply with the Preferential Treatment Rule and Restricted Activities Rule with respect to their non-US funds (including those non-US funds with US investors), unless such a fund is a "similar pool of assets" of a US private fund, in which case, certain parts of the Preferential Treatment Rule will apply to such funds. See Adopting Release, pages 46–47.

[viii] Investment advisers registered with the SEC pursuant to the Advisers Act, including those that do not advise private funds, as such term is defined in the Adopting Release (see footnote vi, above).

[ix] Exempt reporting advisers, foreign private advisers, and all other unregistered advisers are not required to comply with the Compliance Rule under the Advisers Act, and are consequently not affected by the amendments to said rule.

PART 2: RULES APPLICABLE TO ALL PRIVATE FUND ADVISERS

Both Rule 211(h)(2)-3 (the Preferential Treatment Rule) and Rule 211(h)(2)-1 (the Restricted Activities Rule) apply to all private fund advisers, including exempt reporting advisers and unregistered advisers.[39]

The Preferential Treatment Rule prohibits all private fund advisers from (i) granting preferential redemption rights or providing certain information to an investor in a private fund or a similar pool of assets[40] if the adviser reasonably expects it would have a material, negative effect on other investors in that private fund or in a similar pool of assets, and (ii) providing investors with certain preferential rights (such as those provisions typically granted via side letters) without disclosing such preferential rights to other investors. For purposes of the Rules, as discussed in greater detail above, a similar pool of assets is a pooled investment vehicle (other than an investment company registered under the Investment Company Act or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser or its related persons.

In addition, the Restricted Activities Rule prohibits private fund advisers from (i) charging a private fund for (a) certain fees, including allocating or charging a private fund fees on a non-*pro rata* basis, or reducing an adviser's (or related person's) clawback by the taxes applicable to the adviser without proper disclosure and (b) fees related to an investigation, or (ii) borrowing from a client without disclosing such an arrangement and receiving the consent of a majority-in-interest of investors that are not related persons of the adviser.

Portions of both the Preferential Treatment Rule and the Restricted Activities Rule benefit from legacy provisions (more commonly known as "grandfathering" provisions). Where applicable, the portions of the Rules that have such legacy status do not apply to a private fund's governing agreements where (i) the fund has commenced operations as of the compliance date, (ii) the governing agreements were entered into prior to the compliance date, and (iii) the otherwise applicable portion of the Rules would require the parties to amend such governing agreements if the legacy provision did not apply. The SEC clarified that the commencement of operations includes any *bona fide* activity directed toward operating a fund, including investment, fundraising, or operational activity.

The SEC emphasized that the legacy provisions apply only with respect to advisers' *existing* agreements with parties as of the compliance date.[41] Advisers may not add parties to a side letter after the compliance date in order to skirt the prohibitions of the Rules. However, the SEC clarified that it would not view an adviser admitting new investors to an existing fund (after the compliance date) as violating the legacy provision, so long as the otherwise-prohibited terms are (i) set forth in the fund's limited partnership (or similar) agreement, and (ii) applicable to all investors.[42]

We explore the Preferential Treatment Rule and the Restricted Activities Rule in more detail below.

A. THE PREFERENTIAL TREATMENT RULE

I. Prohibited Preferential Treatment (§ 211(h)(2)-3)

Redemption Rights (§ 211(h)(2)-3(a)(1))

Overview

Under the Rules, private fund advisers will be prohibited from granting an investor in a private fund or in a similar pool of assets[43] 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.

The Rules include two exceptions to this prohibition:

i. An adviser will not be prohibited from offering preferential redemption rights if the investor is required to redeem due to applicable laws, rules, regulations, or orders of any government to which the investor, private fund, or any similar pool of assets is subject.[44]

ii. An adviser will not be prohibited from offering preferential redemption rights if the adviser has offered the same redemption ability to all other existing investors without qualification (e.g., no commitment size or affiliation requirements, or other limitations) and will continue to offer such redemption ability to all future investors in the same private fund or any similar pool of assets.[45]

This portion of the Preferential Treatment Rule benefits from the legacy provisions.[46] As such, a fund that has already commenced operations and for which the governing agreements (including side letters) were entered into prior to the compliance date, which the Rules would otherwise prohibit from granting preferential redemption rights—if not for the legacy provisions—may continue to operate under its existing arrangements.

Practical Considerations

Considerations for Sponsors

Use of Waiver Provisions

Given that the assessment of whether a redemption has a material, negative effect on other investors is ultimately a facts and circumstances analysis, this rule may have a chilling effect on advisers' willingness to waive certain redemption restrictions going forward (e.g., such as waiving a minimum 90-day redemption notice requirement on a case-by-case basis). While the Rule does not strip advisers of the authority to waive certain redemption restrictions pursuant to the fund agreement, we expect advisers to do so less frequently, to avoid SEC scrutiny.

Impact on Co-investment Funds

The requirement to offer preferential redemption rights to *all* existing investors in the relevant private fund *and* any similar pool of assets may have a significant impact. A sponsor may have open-end and closed-end products that have similar investment strategies and invest alongside one another in underlying investments. As a practical matter, it would not be feasible for the sponsor of these types of parallel investment structures to offer the same redemption rights to the closed-end fund's investors. In other instances, a sponsor may have a hedge fund that side pockets a position that is also held by a closed-end fund from the same sponsor. Neither the Rule nor the Adopting Release addresses this issue. Advisers will need to proceed with caution when considering how to operate these structures under the Rules so as to reduce regulatory risk.

Applicable Law Carve-Out

The carve-out for applicable laws, rules, regulations, or governmental orders raises some practical questions as to how the SEC will interpret this provision. For example, laws and regulations often do not *require* redemptions by particular investors but, instead, impose additional requirements on investors and/or the private funds in which they invest, which advisers and investors seek to avoid. This ambiguity may impact how managers structure such products, going forward.

Similarly, in certain situations, the determination of whether certain investor-specific liquidity provisions can be attributed to regulatory requirements—and whether such investors can therefore legitimately be provided the sort of preferential treatment that would otherwise be prohibited under the Rule—is less clear. This may affect advisers' willingness to grant these provisions or even to allow participation by investors subject to certain laws, rules, or regulations, going forward.

Impact on Class Shares

Advisers are permitted to offer different share classes with different liquidity options, provided that the share classes are not impermissibly restricted (e.g., only offered to investors of a certain commitment size, affiliated investors, or other limitations) and would not have a material, negative effect on other investors. Conversely, if the adviser incentivizes investors to select one share class over a share class with less liquidity (e.g., by requiring the investor to invest in another of the adviser's funds or agree to uncapped liability), then the SEC will interpret that arrangement as running afoul of the Preferential Treatment Rule.[47]

Considerations for Investors

Availability of Redemption Rights

Wary of potential enforcement risks—particularly in instances where an investor is also granted special informational or notice rights—advisers have been careful in the granting of preferential redemption rights in recent years. Consequently, the Rules' requirement to offer preferential redemption rights to all other investors may, in practice, lead to a complete elimination of the provision of preferential redemption rights to investors.

Availability of Redemption Rights (Large Investors)

Many large investors (such as state pension plans and sovereign wealth funds) frequently negotiate redemption rights in connection with their private fund investments, especially when making a commitment early on in a fund's life. The Rules will place pressure on advisers to determine whether such redemption rights may have a material, negative effect on their other investors where such rights are granted for reasons other than applicable laws, rules, regulations, or government orders. This regulatory pressure will likely limit advisers' willingness to grant such rights.

Applicable Law Exemption

While it is clear from the Adopting Release that the Preferential Treatment Rule was intended to capture current practices for investors that are subject to state or local laws that explicitly require them to redeem their interests under certain circumstances, [48] such as public pension plans, it will likely affect other investors as well. For example, it is not clear what impact the Rule will have on investors subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA). While the Adopting Release seems to indicate that advisers will be permitted to grant preferential liquidity rights to investors subject to ERISA, in order to permit such investors' withdrawal to prevent the fund's assets from becoming "plan assets" under ERISA, the plain text of the Rule indicates otherwise—i.e., that an adviser can only grant an ERISA investor preferential liquidity rights if the adviser offers such rights to each other investor (because ERISA-related withdrawal rights are generally not *required* due to applicable laws, rules, regulations, or orders of any government).

Similarly, church and governmental plans often negotiate with advisers to be treated as pension plans when investing in private funds. However, if such desired treatment is not required by the laws, rules, regulations, or orders that are applicable to such entities, then such a status election will seemingly be prohibited under the Rules, if such treatment would provide any form of preferential redemption right that has a material, negative effect on other investors (unless such right was also offered to all other investors).[49] Investors used to electing into this treatment will need to consider carefully whether other terms sufficiently grant them the ability to exit the fund, as they deem necessary.

Information Rights (§ 211(h)(2)-3(a)(2))

Overview

Private fund advisers may no longer provide information regarding the portfolio holdings or exposures of a private fund or a similar pool of assets to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors, unless the adviser offers such information to all investors at substantially the same time.[50] The SEC noted in the Adopting Release that the ability to redeem is an important factor in determining whether providing information is likely to result in a material, negative effect on other investors and thereby trigger the prohibition.[51] As such, the SEC is likely to view preferential transparency rights granted to investors in liquid funds with more skepticism than similar rights granted to investors in an illiquid fund. For illiquid funds, the SEC indicated that it would generally not view providing preferential information rights to an investor as liable to result in a material, negative effect on other investors, but the issue still requires a facts and circumstances analysis on a case-by-case basis.[52]

This portion of the Preferential Treatment Rule benefits from the legacy provisions.

Practical Considerations

Considerations for Sponsors

NDAs

Advisers that have entered into nondisclosure agreements with certain investors with respect to the preferential information rights granted to such investors will not be exempted from disclosing and offering the same information to each other investor.[53]

Liquid vs. Illiquid

These restrictions are likely to have a greater impact on liquid funds than illiquid funds. The SEC notes in the Adopting Release that advisers are likely to make different assessments in funds where there is not an opportunity for investors to redeem their interest.

Compliance Considerations

As a practical matter, advisers should review investor-specific reporting templates to ensure that they do not contravene these rules. Advisers should also ensure that their policies and procedures are updated with respect to communications made to investors at one-on-one meetings. Ultimately, these rules may reduce the willingness of advisers to share potentially preferential updates with certain investors and/or for advisers to engage in bespoke reporting with certain investors—in each case, for fear that such reporting may be seen a breach of these rules by the SEC—or managers may instead elect simply to provide a one-size-fits-all report to all investors. Advisers may also consider making more frequent disclosures to all investors, as a means of ensuring that all investors are provided with the same information at substantially the same time.

Investment Advisory Committees

Advisers should also consider their approach to providing updates to investor advisory committees, especially where such updates contain information that the adviser does not otherwise share with the wider investor-base. In the context of a liquid fund, these updates may be particularly problematic, as the adviser may be providing certain investors with information that motivates them to liquidate their position, which in turn would have a material, negative effect on other investors that did not receive the information. Advisers to illiquid funds are less susceptible to this issue, but if they also manage liquid funds that are “similar pool of assets,” they must ensure that the information provided to the investment advisory committees of an illiquid private fund does not have a material, negative effect on the investors in the liquid fund.

Similar Pool of Assets

The Rules apply with respect to investors in a private fund *and* any other similar pool of assets. Advisers will need to consider how their interactions with investors in one fund may affect investors in another similar pool of assets, especially where each pool of assets provides differing liquidity options to its investors. This may be particularly burdensome where different teams of an adviser are responsible for its liquid and illiquid funds.

Platform-Level Relationships

For advisers, it is often desirable to create platform-level[54] relationships with their investors. Moving forward, careful thought will need to be given to the specifics of such arrangements, to ensure there are no inadvertent breaches of the information-sharing provisions of the Rules.

Considerations for Investors

General

This portion of the Preferential Treatment Rule may have the most significant impact on investors with deep and wide-ranging relationships with their private fund advisers. These relationships typically cross multiple strategies and fund vintages. Historically, the information sharing between advisers and investors in such relationships has been organic and frequent. However, the Rules will now impose an additional compliance burden on advisers that engage in these activities, which may effectively chill the flow of information in such relationships.

Bespoke Reporting

As stated above, this Rule may cause advisers to be more reluctant to provide bespoke reporting to investors, and investors accustomed to being granted special reporting provisions—such as receiving particular information or the provision of information via a requested, specific template—may need to adjust to being provided one-size-fits-all reports.

Impact on Negotiations

For investors, one consequence of this Rule may be that what was once a relatively standard reporting "ask" may now be subject to significant pushback from advisers, going forward.

Fund of Funds

Sophisticated funds of funds and, increasingly, other investors participating in hedge funds, often rely on fund-level data feeds to manage their portfolios and understand risks. Such real-time information may no longer be made available, as advisers may be wary that allowing access to such data will be perceived as providing preferential information updates only to specific investors (i.e., those capable of accessing and interpreting such data) in contravention of the rule. If this occurs, such sophisticated investors may find it more difficult to successfully manage their investment portfolios with diminished access to this information or may elect to bring in-house certain kinds of strategies.[55]

II. Preferential Treatment Subject to Disclosure (§ 211(h)(2)-3(b))

Overview

All other preferential rights not discussed above are now subject to a disclosure obligation. The Rules require advisers to provide prospective investors with advance written notice[56] of any preferential "material economic terms" granted to any other investor. All other preferential treatment requires:

i. For investors in a liquid fund, written notice to current investors as soon as reasonably practicable[57] following the investor's investment in the private fund;
ii. For investors in an illiquid fund, written notice to current investors as soon as reasonably practicable following the end of a private fund's fundraising period; and
iii. Annual notice of any preferential treatment provided in the period since prior written notice.

In its notice to investors, the private fund adviser must describe the preferential treatment with enough specificity to convey its relevance. By way of example, the SEC noted that it would not be sufficient to disclose the mere fact that other investors are paying lower fees. Rather, the private fund adviser would need to disclose the lower fee terms or, if more than one other investor is paying lower fees, the range of such fees.[58]

The SEC has also amended Rule 204-2 under the Advisers Act (the Books and Records Rule) to require RIAs to retain a copy of any notification, consent, or other document distributed to or received from private fund investors pursuant to the Preferential Treatment Rule, along with a record of each addressee and the corresponding date(s) sent for each document distributed by the investment adviser.[59]

The legacy provisions do not apply to this portion of the Preferential Treatment Rule.

Practical Considerations

Considerations for Sponsors

Legacy Funds

The disclosure requirements apply to all existing funds. Irrespective of whether a fund is still accepting additional capital, advisers will need to ensure that appropriate compendiums of existing side letter terms (or sufficient summaries of such terms) are shared with investors in all of their private funds, to the extent that this has not already taken place.

Impact on Existing Processes

The final rule will prohibit the practice of only providing disclosure of side letter terms to investors who have a corresponding right to elect such provisions under the fund's most favored nation (MFN) provision. This will be a significant change to some advisers' current processes and will lead to changes to many private fund documents going forward.

"Material Economic Terms"

The distinction between "material economic terms" and all other preferential terms is likely to be difficult to ascertain in practice. While the SEC provides some guidelines as to what it believes to be a material economic term (e.g., fee breaks, co-investment rights, and liquidity rights), this will ultimately be a facts and circumstances analysis. For example, in certain situations, excuse rights could be characterized as a material economic term.

Cost Impact

The two-stage disclosure of side letter rights is likely to lead to increased costs for advisers, who may choose to pass such costs on to the relevant fund(s). There has been a trend in recent years of advisers seeking to characterize MFN costs as fund operating expenses, which are generally not subject to a cap, as opposed to fund organizational expenses, which are generally subject to a cap. The relatively burdensome requirements of the new rule may encourage this trend further.

Table 2. *Applicability of Legacy Provisions to the Preferential Treatment Rule and Restricted Activities Rule.*

Preferential Treatment Rule*	Legacy Provision?
Redemption Rights	Yes
Information Rights	Yes
Disclosure Obligations	No
Restricted Activities Rule	**Legacy Provision?**
Regulatory, Compliance, and Examination Fees	No
Reduction of Clawback for Taxes	No
Non-Pro Rata Fee and Expense Allocations	No
Investigation Fees and Expenses	Yes[1]
Borrowing from Clients	Yes

*The legacy provisions do not allow for fees or expenses relating to an investigations relating to violations of the Advisers Act to be charged to private funds. See Part 2: Rules Applicable to All Private Fund Advisers for further details.

Negotiations Going Forward

The pre-disclosure requirement for material economic terms may have a significant impact on closing dynamics. One positive reading is that advisers and investors will be motivated to resolve points having an economic effect early in the fundraising period, to ensure the adviser can meet its disclosure obligations. However, the reality of many closing processes is that “nothing is agreed until everything is agreed.” We expect that some advisers will begin to impose two deadlines on investors: one relating to the agreement of side letter provisions; and a second, later date relating to the actual closing of an investor’s commitment. Potential practical issues may, however, still arise where an investor seeks to reopen negotiations following the disclosure of material economic terms.

Alternatively, fund managers could choose to provide multiple notice updates, up to the close of a fundraise, and provide investors with opt-out rights in each instance. However, providing such rolling notices and opt-out opportunities would likely pose its own set of challenges and frustrations for a fund sponsor, as it would likely impact their ability to gauge when a fund’s target capital raise will be met (which could, in turn, affect its ability to make certain prospective investments) or result in other investors bearing the costs of the manager having negotiated terms with investors who are no longer participating in the fund.

Form of Disclosure

As the SEC did not specify the form that prior disclosure of material economic terms must take, or what specific terms the SEC will expect to be disclosed, these will need to be established through the market implementation of the Rules.

Timing—Illiquid Funds

For illiquid funds, disclosure of all other preferential terms will need to take place “as soon as reasonably practicable” following the fund’s final closing. The SEC has indicated, “it would generally be appropriate for advisers to distribute notices within four weeks of [such] closing.”[60] Currently, such disclosures can sometimes take much longer than the foregoing time period. As such, advisers and their counsel will be subject to additional time pressure in circulating these materials.

Timing—Liquid Funds

For liquid funds, the requirement to disclose information “as soon as reasonably practicable” following the admission of an investor to the private fund is likely to impose additional compliance costs on advisers where subscriptions are accepted monthly or quarterly. Many funds currently limit side letter disclosure to an annual (or other regularly scheduled) process, but this will no longer be possible with respect to the initial disclosure of side letter terms. These additional disclosure requirements are likely to lead to increased costs for funds currently disclosing side letter provisions on a less frequent basis.

Impact on Due Diligence Letters

It remains to be seen what effect these Rules will have on the recent trend of advisers using so-called “diligence letters” to clarify their and their investors’ mutual understanding of the language of certain provisions within fund documents. Typically, both the adviser and said investor(s) agree that such due diligence letters do not establish any new terms between the adviser and such investor(s) or provide any new rights to such investor(s). Therefore, due diligence letters are often seen as falling outside the purview of the MFN process. However, such an approach may be difficult to square with the Rules, given that what constitutes a “side letter”—which was previously a contractual understanding set forth in a fund’s governing documents—has now been articulated in regulatory terms by the SEC. Given that “any separate agreement entered into between a particular investor and an adviser in connection with such investor’s admission to a fund” is now deemed a side letter,[61] the SEC may consider diligence letters to fall within such definition.

Considerations for Investors

Increased Insight

For investors, while an adviser’s obligation to disclose certain terms will not provide a corresponding right to elect into such terms, this disclosure obligation will provide them with increased insight into terms that have been agreed to in the funds in which they have invested. This may inform investors’ standard side letter requests going forward, as investors may adapt to the additional information received through this disclosure process and adjust their expectations accordingly.

Impact on Negotiations

For investors who have often fought hard for disclosure of all side letter terms, this new rule will enable them to concentrate their energies and leverage on the negotiation of other fund terms.

Impact on Large Investors

Investors, such as large institutional investors, that have participated in a number of funds within an adviser’s platform, or otherwise have had a sustained and significant relationship with an adviser, are more likely to have negotiated a number of platform-wide provisions that may now be subject to disclosure under the Rules. Such investors should consider to what extent the disclosure of such terms to other investors may reveal information about their own platform and/or operations. Investors who are concerned about the disclosure of certain information should proactively work with advisers to ensure that their identifying information be redacted prior to disclosure of terms to other investors under these new requirements.[62]

Impact on Small Investors

For smaller or newer investors, the information provided by real-time MFN disclosures could provide welcome insight into the true state of the market as to what terms advisers are regularly agreeing to or providing. More generally, such information will likely better enable all investors to compare what financial terms advisers are providing to other investors, which investors may find helpful when determining where to invest—along with which side letter requests they should make in connection with those investments—in the future.

B. THE RESTRICTED ACTIVITIES RULE [63]

I. Restricted Activities With Disclosure-Based Exceptions

Restricted activities that have disclosure-based exceptions (outlined below) do not benefit from the legacy provisions of the Restricted Activities Rule. As such, advisers will need to consider whether their current private fund documents appropriately authorize each of the following restricted activities. To the extent that the authorizations are considered insufficient, advisers may need to amend or supplement the relevant documents.

Regulatory, Compliance, and Examination Fees (§ 211(h)(2)-1(a)(2))

Overview

The Restricted Activities Rule prohibits a private fund adviser from charging a private fund for (i) the regulatory or compliance fees and expenses of the adviser or its related persons and (ii) fees and expenses associated with an examination of the adviser or its related persons by any governmental or regulatory authority, unless the adviser distributes a written notice of such fees or expenses. Such notice must include the dollar amount thereof and be delivered to the investors in such private fund within 45 days after the end of the fiscal quarter in which the charge occurs.[64]

This portion of the Restricted Activities Rule does not benefit from the legacy provisions.[65]

Practical Considerations

Adviser Policy Updates

Advisers will need to update their operational policies to account for the requirement to report the allocation of such fees and expenses within 45 days following the fiscal quarter in which the relevant charge was made.

General Impact

The move from outright prohibition in the Proposal to a disclosure-based regime will generally be welcomed by advisers who charge such expenses, as this generally follows existing market practice. However, some fund managers, when faced with the requirement to describe and disclose regulatory, compliance, and examination fees in detail, may instead opt to cover these expenses themselves, rather than face investor scrutiny in connection with such disclosure. Managers that choose to avoid disclosure by covering these costs themselves may increase a fund's management or administrative fee(s) to offset their personal out-of-pocket expense.

Expense Details

As the SEC has not specified the extent to which such expenses will need to be detailed, it is an open question as to how granular such disclosures will need to be to adequately comply with the Rule. Such uncertainty may affect advisers' willingness to avail themselves of this exception.

Investor Ability to Benchmark Expenses

Given the recent trend of advisers having regulatory expenses covered by their funds, investors may take some comfort in being kept abreast of the extent of such fees on a quarterly basis, as it will enable them to benchmark fees charged by different funds and fund complexes, to ascertain whether some managers are "off-market."

Reduction of Clawbacks for Taxes (§ 211(h)(2)-1(a)(3))

Overview

Under the Rules, private fund advisers will be prohibited from reducing the amount of an adviser clawback[66] 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 impacted private fund client which sets forth the aggregate dollar amounts of the adviser clawback, both before and after any such reduction. Such written notice must be delivered within 45 days following the end of the fiscal quarter in which the adviser clawback occurs.

This portion of the Restricted Activities Rule does not benefit from the legacy provisions.

Practical Considerations

Updating Policies and Fund Documents

The reduction of clawbacks by the amount of actual and assumed taxes is currently a market standard practice. Advisers will need to ensure that, going forward, they update their internal policies and procedures to ensure that appropriate reporting is made. Additionally, we expect that the governing documents for future private funds will specify that the funds' investors will receive such notice as required by the Rule, in the instance of any such reduction in clawback.

Tax Calculations

While the Rules refer to showing deductions for actual, potential, *or* hypothetical taxes applicable to the adviser, we expect it may be difficult for advisers to show only actual taxes resulting from the receipt of a carried interest, given that individual tax returns include so many variables that impact the final tax amount. As such, we expect that most advisers will use a formula that determines either potential or hypothetical taxes when showing the before and after amounts.

Investor Ability to Benchmark

For investors, this granular level of detail may be helpful in comparing the economic effect of these provisions between advisers in situations where clawbacks arise (though we note that, in practice, such clawbacks do not occur frequently).

Non-Pro Rata Fee and Expense Allocations (§ 211(h)(2)-1(a)(4))

Overview

Generally, the Rules prohibit private fund advisers from directly or indirectly charging or allocating fees or expenses related to a portfolio investment (or a potential portfolio investment) on a non-*pro rata* basis when multiple private funds and other clients advised by the adviser or its related persons 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 investment adviser distributes to each investor in such 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 noted in the Adopting Release that whether an allocation is fair and equitable under the circumstances will depend on the factors relevant to the specific expense.[67] In particular, the SEC noted that where expenses are incurred for the benefit of a particular investor, allocating such expenses in a non-*pro rata* manner may be fair and equitable.[68]

This portion of the Restricted Activities Rule does not benefit from the legacy provisions.

Practical Considerations

Timing Concerns

The disclosure requirements regarding the allocation of non-*pro rata* fees may impose some practical difficulties on advisers, particularly in certain co-investment transactions. Under the Restricted Activities Rule, the disclosure must be made prior to the relevant charge or allocation. In the context of co-investments, it is sometimes the case that co-investors only commit to co-investments at or shortly before the closing of the transaction. This creates a practical timing issue as to what “prior” means in such circumstances, and a potential investment-by-investment question as to just when such fees and expenses are “allocated” to investors.

Similarly, fund managers should carefully consider how to properly allocate broken-deal expenses in connection with co-investments (or any other transactions in which only a portion of a fund’s investors would have been participating) that fall through prior to closing, and ensure that their offering materials clearly describe the allocation in such instances, as the SEC is likely to be more focused on these practices going forward. For example, the current practice of charging broken-deal expenses to all of a fund’s investors may be challenged by the SEC as not being “fair and equitable” under the Rules, on the basis that fund investors are disproportionately bearing the costs of such broken-deal expenses, relative to the share of expenses they would have borne had such co-investment (or other transaction) not fallen through prior to closing.

Parallel Funds and Feeder Funds

Fund documents currently often provide discretion to advisers to disproportionately allocate certain fees and expenses to parallel funds and/or feeder funds if such fees and expenses are attributable to such vehicles. The new prior-disclosure requirement may impose some practical difficulties for some advisers if such allocations are frequent, as it will require such advisers to notify private fund investors with equal frequency.

Potential Structuring Impact

Advisers may seek to allocate fees and expenses across their fund platforms to avoid having to make certain non-*pro rata* fee and expense allocations and consequently have their decisions subjected to SEC review under these new provisions. As such, investors who only need more "plain vanilla" structures may find themselves bearing higher fees and expenses than they historically have, while investors who require more complicated structures may find a corresponding decrease in their expense load.

Exculpation and Indemnification

In the Proposal, the SEC proposed prohibiting a private fund adviser from, directly or indirectly, 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. While the SEC did not adopt that prohibition in the final Rules, it did use the Adopting Release as an opportunity to remind advisers of their obligation to act consistently with their fiduciary duty and legal obligations under the Advisers Act, including the antifraud provisions of section 206—a position previously set forth by the SEC.[69]

II. Restricted Activities With Disclosure- and Consent-Based Exceptions

Investigation Fees and Expenses (§ 211(h)(2)-1(a)(1))

Overview

A private fund adviser may no longer charge private fund clients for fees and expenses associated with an investigation of the adviser or its related persons by any governmental or regulatory authority, unless the adviser (i) seeks consent from all investors of a private fund and (ii) obtains written consent from at least a majority-in-interest of the fund's investors that are not related persons of the adviser. Private fund advisers must seek and obtain this consent, even if the conduct would otherwise be indemnifiable under the applicable private fund governing documents (noting that such governing fund documents must also authorize the right to indemnification for these expenses). However, notwithstanding the foregoing disclosure- and consent-based exception, there is an absolute prohibition[70] on advisers charging private fund clients for fees and expenses related to an investigation that results in a court or government authority imposing a sanction for a violation of the Advisers Act or its rules. If an adviser charges any fees and expenses to a private fund client in connection with an investigation, and is subsequently sanctioned for a violation of the Advisers Act or its rules as a result of such investigation, the adviser must reimburse the relevant fund for the fees and expenses associated with the investigation.

Generally, the legacy provisions apply to this portion of the Restricted Activities Rule. However, the legacy provisions do not allow an investment adviser to continue charging or allocating to a 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 its rules (which is now fully prohibited, as discussed above).[71]

Practical Considerations

General Pre-Consent Not Sufficient

Advisers will be prohibited from allocating the costs of an investigation to a private fund unless it obtains the consent of a majority-in-interest of unaffiliated investors. The Adopting Release states that the SEC expects advisers to obtain separate consents for each investigation being charged to the private fund. As such, it is unlikely to be sufficient for advisers to obtain a general pre-consent to the incurrence of such costs from investors via their fund documents. [72]

Potential Impact

As investors will now be provided the opportunity to consent to specific instances of investigation expenses being reimbursed by a fund—rather than providing their blanket consent as a condition of participating in the fund—they may be more reluctant to actually provide such consent. Fund managers may consequently hesitate to seek such consent, and instead choose to self-fund such expenditures, leaving the door open to seek such consent later if the investigation continues. As with regulatory, compliance, and examination fees,[73] managers who choose to bear more fund expenses out-of-pocket (versus seeking reimbursement from the fund) may choose to mitigate these costs by increasing a fund's management or administrative fee(s).

Disclosure of Regulatory Actions

Many investors currently seek notice of certain regulatory actions, and this requirement will constitute a valuable supplement to such notice(s), if the manager seeks investor consent for the reimbursement of these expenses. Further, many firms currently choose not to disclose the existence of nascent SEC enforcement actions to investors during the investigatory period (with some waiting until their receipt of a Wells notice). The requirement to seek consent for indemnification will likely result in investors learning of potential enforcement actions earlier into a proceeding than they historically would.

Alternatively, advisers reluctant to disclose ongoing investigations to investors may either choose not to seek indemnification, or may choose to self-fund associated expenses initially, and seek reimbursement from investors later.

Borrowing From a Client (§ 211(h)(2)-1(a)(5))

Overview

The Restricted Activities Rule prohibits private fund advisers from borrowing funds, securities, or other assets from a private fund client unless the adviser:

i. Distributes to investors a written notice and description of the material terms of the borrowing;

ii. Seeks the consent of the private fund’s investors; and

iii. Obtains written consent from at least a majority-in-interest of the fund’s investors that are not related persons of the adviser.

Notably, the Restricted Activities Rule does not define the material borrowing terms that must be disclosed. However, the Adopting Release indicates that such material terms may, depending on facts and circumstances, include the amount of money to be borrowed, the interest rate, and the repayment schedule.[74] The Restricted Activities Rule 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, such as a bank that is invested in the fund. The Adopting Release also clarifies that the SEC would not interpret ordinary course tax advances and management fee offsets as borrowings that are subject to the Restricted Activities Rule.

The legacy provisions apply to this portion of the Restricted Activities Rule. As such, a fund that has already commenced operations and for which the governing agreements were entered into prior to the compliance date, which would otherwise be prohibited from engaging in such borrowing by the Rules—if not for the legacy provisions—may continue engaging in such borrowing.

Practical Considerations

Updates to Fund Documents

While few advisers actually engage in this activity, those that do will need to ensure that the relevant disclosures are included in any future fund documents and that the necessary consents are received prior to engaging in any such borrowing.

Limited Impact of the Rule

Given the limited nature of this activity, we do not believe investors are likely to receive this kind of consent request frequently. However, when a private fund adviser does borrow from a private fund client, we expect the provided information to be useful for investors weighing the level of potentially adverse conflicts of interest.

PART 3: RULES APPLICABLE TO REGISTERED PRIVATE FUND ADVISERS

Rule 211(h)(1)-2 (the Quarterly Statement Rule), Rule 206(4)-10 (the Private Fund Audit Rule), and Rule 211(h)(2)-2 (the Adviser-Led Secondaries Rule) only apply to RIAs that advise private funds. The Quarterly Statement Rule requires such advisers to provide quarterly statements that include specific information regarding fees, expenses, and performance for each private fund that it advises, and to distribute such statement(s) within a certain time period. The Private Fund Audit Rule requires RIAs that provide investment advice, either directly or indirectly, to a private fund to cause such fund to undergo a financial statement audit that meets certain requirements of section 206(4)-2 of the Advisers Act (the Custody Rule), and to deliver such audit in accordance with the requirements of the Custody Rule. The Adviser-Led Secondaries Rule requires SEC-registered private fund advisers engaged in an adviser-led secondary[75] with respect to a private fund that it advises to distribute to investors in the private fund either a fairness or valuation opinion, as well as a summary of any material business relationship the adviser has with the opinion provider.

Importantly, unlike certain parts of the Preferential Treatment and Restricted Activities Rules, the SEC did not include legacy provisions for any of the rules discussed in this Part 3.[76] As such, each of the Quarterly Statement Rule, the Private Fund Audit Rule, and the Adviser Led-Secondaries Rule will apply to existing private funds managed by RIAs, irrespective of the terms of the existing governing documents of such funds.

A. THE QUARTERLY STATEMENT RULE (§ 211(h)(1)-2)

Overview

The Quarterly Statement Rule requires that (i) for the first three quarters of a fund's fiscal year, a quarterly statement be delivered within 45 days of the end of each quarter (or 75 days, if such fund is a fund of funds) and (ii) for the final quarter of a fund's fiscal year, a quarterly statement be delivered within 90 days of the end of that quarter (or 120 days, if such fund is a fund of funds).

The Quarterly Statement Rule requires RIAs to provide, for each private fund it advises, both fund-level and portfolio-level information, as well as performance information and disclosures. Specifically, it requires that each quarterly statement include:

i. A fund-level table with a detailed accounting of all compensation paid or allocated to the adviser and its related persons, fund fees and expenses, and any fee offsets or rebates carried forward during the reporting period to the following quarterly period to reduce future payments or allocations to the adviser;
ii. A portfolio investment-level table including a detailed accounting of all portfolio investment compensation[77] allocated or paid to the RIA or its related persons by each covered portfolio investment during the reporting period;
iii. For liquid funds, standardized investment performance information, including:
    a. Annual net total return for each fiscal year over the past 10 fiscal years or since inception;
    b. Average annual net total returns over one, five and 10 fiscal-year periods (if applicable); and

    c. Cumulative net total returns for the current fiscal year as of the end of the most recent fiscal quarter covered by the quarterly statement;

iv. For illiquid funds, standardized investment performance information since such fund's inception through the end of the covered fiscal quarter, including:

    a. The fund's gross and net internal rate of return (IRR) and multiple on invested capital (MOIC), calculated both with and without the impact of fund-level subscription facilities;
    b. The fund's gross IRR and MOIC for the realized and unrealized portions of such fund's portfolio, calculated both with and without the impact of fund-level subscription facilities, with the realized and unrealized performance shown separately; and
    c. A statement of contributions and distributions; and

v. Prominent disclosures regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets were calculated and cross-references to the applicable sections of the private fund's organizational documents.

The Quarterly Statement Rule also sets forth formatting requirements for the reports, intended to improve readability and facilitate the comparison of funds by investors. The Quarterly Statement Rule requires the RIA to use "clear, concise, plain English" in each quarterly statement. It also requires payments, allocations, fees, and expenses to be listed as separate line items by total dollar amount per specific category. RIAs are prohibited from excluding *de minimis* expenses, grouping smaller expenses into broad categories, or labeling expenses as "miscellaneous."[78] Each category of performance information must also be displayed with equal prominence. Where applicable, RIAs must present the dollar amount of compensation, fund expenses, and portfolio investment compensation before and after reductions due to offsets, rebates, or waivers for the reporting periods.

In the Adopting Release, the SEC noted that if quarterly statements are delivered to investors through a data room, it should done in accordance with the SEC's guidance regarding electronic delivery.[79]

The SEC also amended the Books and Records Rule to require RIAs to maintain: copies of any distributed quarterly statement; a record of each addressee and the date(s) of delivery; records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any quarterly statement delivered to investors; and records substantiating the RIA's determination that a private fund is a liquid fund or an illiquid fund.[80] If an adviser distributes a quarterly statement electronically through a data room, the adviser must also keep a record of the notification to investors that the quarterly statement was made available in the data room.[81]

Practical Considerations

Considerations for Sponsors

Legacy Funds

There is no legacy provision for the Quarterly Statement Rule. Accordingly, advisers will need to ensure that such reports are delivered for existing funds, irrespective of where such funds are in their lifecycle. This requirement could be particularly burdensome and costly for closed-ended funds that are no longer investing and are nearing the end of their term.

Increase in Costs

The quarterly statement requirement is likely to impose additional costs on RIAs. For example, the Quarterly Statement Rule requires advisers to produce quarterly statements for all four quarters.[82]

Advisers have historically sought to limit the need to produce a quarterly statement for the fourth quarter, on the basis that funds typically provide annual audited financial statements to investors. Relying on the provision of annual audited financial statements will no longer be possible for RIAs, and advisers will have to update their reporting processes and external arrangements with service providers to ensure that the reporting is delivered in line with the new rule.

Table 3. *Applicability of Legacy Provisions to the Quarterly Statement, Private Fund, and Adviser-Led Secondaries Rules.*

Rule	Legacy Provision?
Quarterly Statement Rule	No
Private Fund Audit Rule	
Adviser-Led Secondaries Rule	

Required Timelines

The deadlines for delivery of quarterly statements are likely to have a material impact on advisers, particularly as many managers currently deliver their quarterly reports within timeframes significantly longer than those set forth in the Rules.

The delivery timeline of quarterly statements under most private fund documents is typically subject to a reasonableness standard, which has not been included in the Quarterly Statement Rule. While the SEC stated that it would be unlikely to take enforcement action if the required timelines are not met due to "*unforeseen circumstances,*" such circumstances are likely to be limited in practice. Accordingly, the Rule represents a tightening of the compliance burden of these reporting provisions going forward. To comply, advisers may need to implement new arrangements with their portfolio investments and/or service providers, to ensure such parties are delivering the information required by advisers to generate and deliver their quarterly statements within the expected timeframes.

Enforcement Risk

As is already the case, advisers will need to be careful to ensure the accuracy of all of the information provided in the quarterly statements, as any errors in such reports could provide the SEC with additional reason to bring an enforcement action, or raise additional issues during examinations. We expect the Quarterly Statement Rule to be an additional focus for SEC staff in examinations and could result in enforcement activity in a manner analogous to the requirement to timely distribute audited financials to private fund investors under the Custody Rule's annual audit exception.[83]

Form and Content Reports

The Quarterly Statement Rule lays out significant requirements regarding the form and content of quarterly reports. Even if RIAs are already providing quarterly statements, the form and content of such reports are unlikely to comply fully with the final Rules. All advisers should start reviewing their standard forms and prepare to bring these into compliance for the implementation date. Given that the

Quarterly Statement Rule also requires certain "*prominent*" disclosures be made in these reports (e.g., cross-references to sections of the private fund's organizational and offering documents), counsel input (which to-date has been limited, with respect to these reports) may be required.

Updates to Fund Documents

The requirement to include cross-references to the relevant underlying, governing fund documents in each quarterly statement may ultimately require amendment to such documents.

Impact on Non-RIAs

While the Quarterly Statement Rule only applies to RIAs, as noted above, we expect that out-of-scope advisers may see pressure from investors to adhere to these guidelines, once the market settles regarding the expected form and content of these reports.

Fund of Funds

While the Adopting Release does not explicitly define a "fund of funds," it does provide an example: "For purposes of the final rule, one example of a fund of funds would be a private fund that invests substantially all of its assets in the equity of private funds that do not share its same adviser and, aside from such private fund investments, holds only cash and cash equivalents and instruments acquired to hedge currency exposure."[84] While advisers can likely depend on previous SEC guidance,[85] it remains to be seen whether advisers to funds that make both direct investments *and* fund investments will receive further explicit guidance from the SEC staff as to their reporting deadlines.

Interaction With the Marketing Rule

The SEC purposely did not align the performance reporting standards with the approach reflected in the Marketing Rule.[86] However, advisers must be wary of the manner in which they deliver the quarterly statements to their potential investors. If advisers deliver quarterly statements to potential investors in such a way that renders the quarterly statements an "advertisement" (as such term is defined in the Marketing Rule), [87] such quarterly statement must then abide by the requirements of the Marketing Rule. Relatedly, to the extent an adviser intends to re-use quarterly statements for an advertising purpose (e.g., in response to a diligence request or posting in a data room), such quarterly statements should be reviewed and revised, to be brought into compliance with the Marketing Rule.

Considerations for Investors

Ability to Compare

Many investors will welcome the SEC's decision to standardize reporting, anticipating that it will help them to compare the performance of the various managers and funds in which they invest.

Investor-Specific Reporting

Advisers may resist investor-specific requests going forward, such as the use of specific reporting templates, pointing to their compliance with the Quarterly Statement Rule. We also note that the effect of the Quarterly Statement Rule may also interact with the Preferential Treatment Rule, and result in the further chilling of bespoke reporting to, and sponsor communications with, investors.

Cost Impact

As the cost of the additional reporting required by the Quarterly Statement Rule will likely be allocated by advisers to a fund's operating expenses, the Rule may impact returns for investors in such funds. Conversely, it may be the case that the more uniform reporting required by the Quarterly Statement Rule decreases the amount of bespoke reporting expected by investors in the long term, thereby lowering the costs associated with generating reports.

B. THE PRIVATE FUND AUDIT RULE (§ 206(4)-10)

Overview

RIAs will be required to obtain an independent annual financial statement audit of each of the private funds that they advise (either directly or indirectly). For those private fund clients that an adviser does not control (and that are neither controlled by, nor under common control with, the adviser),[88] an adviser must take "all reasonable steps" to have such funds audited.

Such financial statement audit must meet the requirements of paragraphs (b)(4)(i)—(b)(4)(iii) of the Custody Rule.

A private fund's audited financial statements must be distributed to current investors within 120 days of the end of the fund's fiscal year (or, in the case of a fund of funds, 180 days).

For those private fund clients that an adviser is not in a control relationship with, the SEC explained in the Adopting Release that what will constitute "all reasonable steps" with respect to obtaining an audit for a fund will be a facts and circumstances determination. The SEC explained that an adviser is in the best position to evaluate its control relationships over its private funds clients, and is consequently in the best position to determine the appropriate steps to satisfy this standard, based on their relationship with the private fund client and the relevant control person(s). For example, the SEC explained that a sub-adviser with no affiliation to the general partner of a private fund could meet this standard by documenting its efforts to include the audit requirement in its sub-advisory agreement.[89]

The SEC also amended the Books and Records Rule to require RIAs to maintain copies of audited financials, as well as a record of each addressee and the date(s) such documents were sent. RIAs will also be required to keep a record of the 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 complies with the Private Fund Audit Rule.[90]

Practical Considerations

Considerations for Sponsors

Legacy Funds

There is no legacy provision for the Private Fund Audit Rule. As such, all RIAs will need to ensure all of their existing private funds are in compliance with this new rule. To the extent advisers to historic funds are not currently relying on the "audit exception"[91] to the Custody Rule, and instead comply with the notice and surprise examination requirements thereunder, the relevant affected funds may incur additional operating expenses as they begin conducting annual audits.[92]

The burden of increased costs will likely be particularly acute for special purpose vehicles (SPVs) and other smaller funds, for which the cost of an annual audit may represent a proportionately larger increase in fund expenses. This new requirement may, in fact, have an unintentional chilling effect on the creation of SPVs or any other small or "one-off" funds.

Interaction With the Custody Rule

Unlike the Proposal, the specific requirements for the audit mandated by the Rules align with the requirements for audits outlined in the Custody Rule. Given that the vast majority of RIAs that advise private funds already seek to comply with the Custody Rule, by causing their funds to distribute audited annual financial statements, we expect the impact of the Private Fund Audit Rule to be limited in scope.[93]

Advisers Not Using the Audit Exemption

Some RIAs do not rely on the annual audited financial statement exemption of the Custody Rule. For such advisers, the Private Fund Audit Rule may lead to additional costs and a new compliance burden.

Auditing Firm Shortage

Audits will need to be performed by an independent public accountant registered with and subject to regular inspection by the Public Company Accounting Oversight Board. It is not clear whether there are enough such auditing firms to be able to handle the influx of funds that will need to be audited. It is likely that this issue will be exacerbated if the proposed Safeguarding Rule is adopted as proposed.

Funds of One

Advisers that advise a fund of one structured as a limited partnership or a limited liability company are required to have such fund of one undergo an audit (to the extent an audit is not already required).

Considerations for Investors

Cost Impact

As with the Quarterly Statement Rule, most advisers will likely allocate the expense of an annual audit to a fund's operating expense. Consequently, this new audit requirement may impact investors' returns from such funds.

C. THE ADVISER-LED SECONDARIES RULE (§ 211(h)(2)-2)

Overview

In connection with any adviser-led secondary transaction, RIAs to a private fund must now distribute to investors either a fairness opinion or a valuation opinion from an independent opinion provider prior to the due date of the transaction's election form.[94] Advisers will also need to provide a written summary of the material business relationships between the adviser and the opinion provider during the two-year period prior to the issuance date of the opinion.[95] While the SEC noted that the determination of whether a business relationship is material will require an analysis of the relevant facts and circumstances of each situation, for purposes of the Adviser-Led Secondaries Rule, engagement for audit, consulting, capital raising, investment banking, and similar services would typically meet the standard.[96]

Whether a secondary is initiated by an adviser also requires a facts and circumstances analysis. However, the SEC would generally consider a transaction to be initiated by the adviser 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. Conversely, if an adviser, at the unsolicited request of an investor, assists in the secondary sale of the investor's fund interest, the SEC will generally not view such transaction as having been initiated by the adviser.[97]

If RIAs deliver fairness opinions and valuation opinions to investors through a data room, the SEC indicated that they should do so in accordance with the SEC's prior guidance on electronic delivery.[98]

The SEC also amended the Books and Records Rule to require RIAs to maintain copies of any fairness opinions or valuation opinions, as well as the material business relationship summaries that are distributed pursuant to the Adviser-Led Secondaries Rule, and a record of each addressee and the date(s) sent. [99]

Practical Considerations

Considerations for Sponsors

Cost Impact

The Rules provide advisers with the option to obtain either a fairness opinion *or* a valuation opinion when conducting an adviser-led secondary. Valuation opinions typically are less expensive to obtain than fairness opinions. As such, this approach should limit the cost-impact of the rule, as compared to how the rule was initially proposed (i.e., requiring a fairness opinion).

Impact on Smaller Adviser-Led Transactions

Acquiring a fairness or valuation opinion in connection with an adviser-led secondary aligns with current industry practices for private equity funds, particularly in the case of mid-market, upper middle market, and large-cap transactions. However, the opinion requirement applies to all adviser-led secondaries. The SEC rejected suggestions from commentators that such a requirement should only apply to transactions above a particular size, or that there should be an option for advisers to rely on market-sourced pricing (which is an approach that some advisers take presently). As such, for smaller adviser-led secondary transactions, the requirement of providing a fairness opinion or valuation opinion may add significant costs to such transactions, which may inhibit solutions to cleaning up end of fund life legacy positions.

Summary of Material Business Relationships

It is not clear at this stage how detailed the summary of material business relationships with the opinion provider—which needs to be provided alongside the valuation or fairness opinion—will need to be. A mere statement that there is a material business relationship is unlikely to be sufficient. It may take some time before the market settles on the level of detail that should be provided.

Timing Requirements

The requirement that the fairness or valuation opinion and material business relationships summary be delivered prior to the due date of the election form is unlikely to have a significant impact on secondary transactions. Investor expectation has typically required the delivery of such information prior to the delivery of their election forms, in any event.

Interaction With Form PF Requirements

The Adviser-Led Secondaries Rule dovetails—but does not excuse noncompliance—with the new Form PF requirements recently adopted by the SEC, which require RIAs to private equity funds with at least US$150 million in private fund assets under management to file on a quarterly basis a report of any adviser-led secondary transactions within 60 days of the end of each fiscal quarter. Advisers will need to make sure that they are tracking and following the requirements of the Rules, as well as both the Form PF and Custody Rule requirements, as applicable.

Considerations for Investors

Cost Impact

As with the Quarterly Statement Rule and Private Fund Audit Rule, the cost of a fairness opinion or valuation opinion required by the Adviser-Led Secondaries Rule will likely be allocated by advisers to a fund's operating expenses and accordingly impact investors' returns.

Negotiations Going Forward

Investors that participate in adviser-led secondaries are likely to welcome the new rule, as they will no longer need to negotiate for the provision of a valuation or fairness opinion by the adviser in connection with such transactions.

PART 4: RULES APPLICABLE TO ALL REGISTERED INVESTMENT ADVISERS

A. COMPLIANCE RULE AMENDMENTS (§ 206(4)-7)

Overview

The Rules include amendments to Rule 206(4)-7 under the Advisers Act (the Compliance Rule) that require RIAs to document the annual review of their compliance policies and procedures in writing. The Compliance Rule amendments will apply to all RIAs, regardless of whether they advise private funds. While, in practice, many advisers already prepare written reports of their annual compliance, the Compliance Rule did not previously require advisers to memorialize their reviews in writing.

Table 4. *Applicability of Legacy Provisions to the Rules Applicable to the Compliance Rule Amendments.*

Rule	Legacy Provision?
Compliance Rule Amendments	No

Practical Considerations

Application to All Advisers

As noted above, the Compliance Rule is relevant to all RIAs, irrespective of whether they advise private funds. As such, while most advisers already comply with this rule in practice, any advisers that do not should update their policies and procedures to bring themselves into compliance as soon as practicable, noting that—unlike other parts of the Rules—there is no implementation period for the amendments to the Compliance Rule (which are already in effect).

PART 5: KEY DATES FOR IMPLEMENTATION

Below is a general overview of the timelines for implementation and/or compliance with the Rules. The Rules are effective 13 November 2023 (the Effective Date).[i, ii]

***Table 5.** Private Fund Adviser Rules: Implementation and Compliance Timelines*

Rule	Large Advisers[iii]	Small Advisers[iv]
Rules Applicable to All Private Fund Advisers: [vi]		
Preferential Treatment Rule[v]	14 September 2024 (10 months from the Effective Date)	14 March 2025 (16 months from the Effective Date)
Restricted Activities Rule[v]		
Rules Applicable to All Registered Investment Advisers to Private Funds:		
Quarterly Statement Rule	14 March 2025 (16 months from the Effective Date)	
Private Fund Audit Rule		
Adviser-Led Secondaries Rule	14 September 2024 (10 months from the Effective Date)	14 March 2025 (16 months from the Effective Date)
Rules Applicable to All Registered Investment Advisers:		
Compliance Rule Amendments	13 November 2023 (60 days following publication in the Federal Register)	

[i] The Federal Register, page 63206.

[ii] For those reading this guide alongside the Adopting Release, note that—while all references to the date of expected compliance in the Adopting Release are made with reference to the date of the Rules' publication in the Federal Register—pursuant to the Small Business Regulatory Enforcement Fairness Act of 1996, any "major rules" (as such term is defined in that act) must be published 60 days prior to the date on which they become effective (i.e., the Effective Date). Consequently, whereas the Adopting Release and Federal Register make reference to (e.g.) "12 months after date of publication in the Federal Register" (see Adopting Release, page 315; Federal Register, page 63291), we have adjusted the wording of the timelines in the chart above to reflect that the Rules' publication established an Effective Date.

[iii] "Large Advisers": Advisers with over US$1.5 billion in regulatory assets under management attributable to private funds.

[iv] "Small Advisers": Advisers with under US$1.5 billion in regulatory assets under management attributable to private funds.

[v] The Preferential Treatment Rule and Restricted Activities Rule are subject to legacy provisions, by which the investor-consent aspects of the Restricted Activities Rule and the prohibitions aspects of the Preferential Treatment Rule—which are otherwise mandatory under the new rules—will not be required for governing agreements (including side letters) that were entered into prior to the compliance date, if the applicable rule would require the parties to amend the agreements. Please see Part 2: Rules Applicable to All Private Fund Advisers for further details.

[vi] Certain rules within the set of new private fund adviser rules apply to all investment advisers to private funds, regardless of registration status. Other rules are applicable only to those advisers registered with the SEC pursuant to the Advisers Act (such advisers, Registered Investment Advisers). Please see *Table 1* in Part 1 for a high-level summary, and the remainder of the guide, for further details.

CONCLUSION

The Rules will impose a number of new requirements on investment advisers, including those currently operating as exempt reporting advisers or those exempted from registration with the SEC entirely. As discussed, uncertainties remain as to the SEC's practical expectations for compliance with regard to certain Rules, and the full implications of the Rules—for advisers and investors alike—remain to be seen. We will carefully track any important developments and guidance as more information is released and market standards are established.

Please reach out to your K&L Gates team with any questions regarding the Rules or for assistance with any implementation or compliance needs.

ENDNOTES

[1] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, SEC Release No. IA-6368 (Aug. 23, 2023). The Rules were officially published to the Federal Register, Vol. 88, No. 177 (the Federal Register) on September 14, 2023. Any citations to the Rules herein are made with respect to the Rules as published in the Federal Register. Any citations to the Adopting Release herein are made with respect to the Adopting Release as republished on September 14, 2023 (i.e., as "[c]onfirmed to the Federal Register version").

[2] In its Adopting Release, the SEC clarified that the Rules are intended to apply to "private funds" as such term is defined in section 202(a)(29) of the Advisers Act (i.e., for purposes of the Rules, a private fund is any issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act). Adopting Release, footnote 4, page 7.

[3] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, SEC Release No. IA-5955 (Feb. 9, 2022).

[4] While the Rules will take effect in accordance with the timeframes set out in Part 5: Key Dates for Implementation, we note that a number of private fund industry groups have filed a petition for review in the United States Court of Appeals for the Fifth Circuit seeking to vacate and invalidate the Rules. The petition for review alleges, among other things, that the Rules exceed the SEC's statutory authority and that the SEC adopted the Rules in violation of the Administrative Procedure Act. As of the date of this guide's publication, the petition for review has not affected the implementation timeframe for the Rules, as set forth in Part 5. As the petition for review was only recently filed, and may not be resolved before the first of the Rules' compliance dates is reached (see Part 5 for details), advisers to private funds should currently proceed as though the Rules will be implemented as published.

[5] Advisers Act, section 206(4)-1. See also *Investment Adviser Marketing*, SEC Release No. IA-5653 (December 22, 2020).

[6] See *Form PF; Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers; Requirements for Large Private Equity Fund Adviser Reporting,* SEC Release No. IA-6297 (May 3, 2023).

[7] See *Safeguarding Advisory Client Assets*, SEC Release No. IA-6240 (February 15, 2023).

[8] The Rules impact three categories of investment advisers: (i) all registered investment advisers; (ii) registered investment advisers that advise private funds; and (iii) advisers (both registered and unregistered) that advise private funds (including exempt reporting advisers). See *Table 1* in Part 1 for a summary of the applicability of the Rules.

[9] The Rules, section 211(h)(1)-1 (definition of "related person").

[10] See Part 2: Rules Applicable to All Private Fund Advisers for details of the Restricted Activities Rule and Preferential Treatment Rule.

[11] See "Similar Pools of Assets" in Part 1 for further discussion; see also Part 2: Rules Applicable to All Private Fund Advisers.

[12] See Part 4: Rules Applicable to All Registered Investment Advisers for further details of the Compliance Rule.

[13] I.e., the Preferential Treatment Rule, the Restricted Activities Rule, the Quarterly Statement Rule, the Private Fund Audit Rule, and the Adviser-Led Secondaries Rule.

[14] As such term is used in the Rules; see endnote 2, above, and *Section I. Private Funds, Generally* in Section B: Applicability to Different Types of Funds, below.

[15] See Part 2: Rules Applicable All Private Fund Advisers for further details.

[16] See footnotes i and ii to *Table 1. Applicability of the Rules to the Different Types of Investment Advisers* in Part 1 for further details.

[17] The above is a high-level summary of exclusions from the definition of "investment adviser"; see section 202(a)(11) of the Advisers Act for details.

[18] See footnote iii to *Table 1. Applicability of the Rules to the Different Types of Investment Advisers* in Part 1 for further details.

[19] See Part 2: Rules Applicable to All Private Fund Advisers for further details on the Preferential Treatment Rule and Restricted Activities Rule.

[20] See Adopting Release, page 7.

[21] I.e., those funds that are not required to register as investment companies with the SEC because they are exempted from the definition of an "investment company" under the Investment Company Act, by limiting investor participation to 100 beneficial owners and/or to only qualified purchasers. See endnote 2, above.

[22] See discussion of "Private Funds" in Part 1, Section B; see also endnote 2, above.

[23] Advisers Act, Rule 203(m)-1.

[24] Advisers Act, Rule 203(m)-1(d)(5).

[25] Investment Company Act, section 3(a)(1).

[26] The Rules, section 211(h)(1)-1 (definition of “similar pool of assets”).

[27] See endnote 2, above.

[28] See Adopting Release, page 284.

[29] See Adopting Release, pages 282–283.

[30] See Adopting Release, footnote 857, page 282.

[31] See Adopting Release, page 282. The SEC declined to include separately managed accounts in the definition of “similar pool of assets.” However, the SEC did note that, in certain circumstances, “a fund of one or single investor fund can be a pooled investment vehicle and therefore can fall within the definition of ‘a similar pool of assets.’” Adopting Release, page 285.

[32] See “Qualifying Private Funds” in Part 1, Section B for further discussion.

[33] See Adopting Release, page 282. For further discussion of similar pools of assets, see “Similar Pools of Assets” in Part 1, Section B.

[34] See Adopting Release footnote 1307, page 422.

[35] This definition aligns with the SEC’s definition of SAFs within Form PF and Form ADV. See Adopting Release, pages 53–55.

[36] See Adopting Release footnote 156, page 53.

[37] Adopting Release, page 53.

[38] Adopting Release, pages 53–54.

[39] As discussed in Part 1: Scope of the New Private Fund Adviser Rules, the Rules do not apply to non-US registered (and unregistered) investments advisers with respect to their non-US funds (regardless of whether those funds have US-based investors). See Adopting Release, page 49.

[40] See “Similar Pool of Assets” in Part 1, Section B for further discussion.

[41] Adopting Release, page 315.

[42] See Adopting Release, page 315.

[43] See the discussion of “Similar Pools of Assets” in Part 1.

[44] This exception does not include redemptions pursuant to an investor’s own policies or resolutions. See Adopting Release, page 274.

[45] This exception does not require that all investors have the same redemption rights—only that they be offered the same redemption rights. See Adopting Release, page 274.

[46] The Rules, section 211(h)(2)-3(d). See *Table 2* for a summary of the applicability of legacy provisions to the different components of the Preferential Treatment Rule.

[47] Adopting Release, pages 275—276.

[48] See Adopting Release, page 274 (noting that the SEC declined to provide an “exception for more informal arrangements, such as policies and resolutions”).

[49] See Adopting Release, page 274 (noting that the SEC declined to provide an “exception for more informal arrangements, such as policies and resolutions”).

[50] In the Adopting Release, the SEC explained that prohibiting certain preferential transparency rights was necessary to protect investors, reasoning that if one investor receives preferential information about the fund’s holdings while another investor does not, the investor with preferential information may use that information to redeem from the fund during the next redemption cycle, even if both investors otherwise have the same redemption rights. See Adopting Release, page 277.

[51] See Adopting Release, page 281.

[52] Adopting Release, pages 281—282.

[53] See Adopting Release, pages 280–281. See also Adopting Release, pages 333–334.

[54] An investment adviser’s “platform” refers to its suite of private fund offerings, typically spanning sectors, strategies, or geographies. Investors that invest across multiple private funds on an adviser’s platform are often granted preferential terms for doing so.

[55] Similarly, some large institutional investors currently employ outside firms to access and interpret this data for them, and may face a similar struggle.

[56] The SEC does not prescribe a delivery method, but notes that electronic delivery through a data room (such as an electronic portal) will be acceptable. See Adopting Release, page 296. However, any electronic delivery should be made in accordance with the SEC’s guidance on electronic delivery. See footnote 435 of the Adopting Release for the SEC’s outlined sources of guidance regarding electronic delivery, page 149.

[57] What constitutes “as soon as reasonably practicable” will depend on a facts and circumstances analysis. However, while the SEC does not prescribe an amount of time that would satisfy this requirement, it indicated that furnishing notices within four weeks would generally be appropriate. See Adopting Release, page 295.

[58] Adopting Release, page 293.

[59] Pursuant to the Books and Record Rules, RIAs must maintain and preserve such records in an easily accessible place for no less than five years from the end of the fiscal year during which the last entry was made on such record, and these records must be in an appropriate office of the investment adviser for the first two years of that period. Adopting Release, page 411.

[60] Adopting Release, page 295.

[61] See Adopting Release, page 266.

[62] While the Rules require the disclosure of certain specifics, the SEC has clarified that disclosure obligations can be met while redacting the identifying information of investors. See Adopting Release, page 293.

[63] The Rules, section 211(h)(2)-1.

[64] Advisers to funds of funds should be cautious of the different timelines required by the Restricted Activities Rule, for disclosures, and by the Quarterly Statement Rule, for the provision of quarterly statements. Such advisers are still required to meet the Restricted Activities Rule’s 45-day disclosure deadline, despite the fact that they will be required to provide some of the same information again, pursuant to the Quarterly Statement Rule, 75 days following the fiscal quarter end.

[65] See *Table 2* above for a summary of the applicability of legacy provisions to the different components of the Restricted Activities Rule.

[66] An “adviser clawback” is defined 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. The Rules, section 211(h)(1)-1 (definition of “adviser clawback”).

[67] See Adopting Release, page 228.

[68] The SEC suggested examples of such situations include creating a bespoke structuring arrangement for one private client fund’s participation in a portfolio investment, or obtaining certain insurance policies required only by particular investors. See Adopting Release, page 228.

[69] See *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. IA-5248 (June 5, 2019). In the retail investor context, the SEC has been flagging hedge clauses as deficiencies in the documents of private fund managers. See, e.g., SEC Administrative Proceeding File No. 3-20700.

[70] Such prohibition is consistent with the Proposal; the SEC did not modify its stance on charging investigation fees connected with violations of the Advisers Act in the final Rules. See Adopting Release, page 234.

[71] See Adopting Release, page 234.

[72] While an adviser likely cannot obtain a general consent to investigation expenses in advance by including a disclosure of such potential future costs in its fund documents, the fund documents must still include language authorizing the right to reimbursement for such expenses. See Adopting Release, footnote 716, page 237.

[73] See the discussion of Practical Considerations in “Regulatory, Compliance, and Examination Fees.”

[74] Adopting Release, page 244.

[75] An “adviser-led secondary” is any transaction initiated by an adviser, by which fund investors are offered the option 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. The Rules, section 211(h)(1)-1 (definition of “adviser-led secondary transaction”).

[76] See *Table 3* below for a summary of the applicability of legacy provisions to each of the Quarterly Statement Rule, Private Fund Audit Rule, and the Adviser-Led Secondaries Rule.

[77] “Portfolio investment compensation” means any compensation, fees, and other amounts allocated or paid by the covered portfolio investment, attributable to the fund’s interest in such portfolio investment, to the investment adviser or any of its related persons, and includes origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees, or similar fees or payments. The Rules, section 211(h)(1)-1 (definition of “portfolio investment compensation”). See also Adopting Release, pages 93–94.

[78] Adopting Release, page 78.

[79] Adopting Release, pages 149–150. See footnote 435 of the Adopting Release for the SEC’s outlined sources of guidance regarding electronic delivery, page 149.

[80] See endnote 59, above, for a brief description of the general recordkeeping requirements of the Books and Records Rule.

[81] Adopting Release, footnote 453, page 157.

[82] The Rules, section 211(h)(1)-2(a).

[83] See https://www.sec.gov/news/press-release/2023-168.

[84] See Adopting Release, footnote 421, page 143.

[85] While the SEC declined to provide a definition for “fund of funds” in the Rules, the SEC has frequently cited the same definition as provided in its “Staff Responses to Questions about the Custody Rule” (the Custody Rule FAQs) to define what constitutes a fund of funds. Per the Custody Rule FAQs, “[a] fund of funds is a pooled investment vehicle that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person of the pool, its general partner, or its adviser.” However, it is not yet clear whether this definition broadly carries over to the context of the Rules, and further guidance from the SEC would be instructive.

[86] See Adopting Release, page 105.

[87] Advisers Act, section 206(4)-1(e)(1).

[88] In the Adopting Release, the SEC provides the example of an adviser to a fund of funds selecting an unaffiliated sub-adviser to implement a portion of the underlying investment strategy. See Adopting Release, page 162.

[89] See Adopting Release, page 182.

[90] See endnote 59, above, for a brief description of the general recordkeeping requirements of the Books and Records Rule.

[91] I.e., section 206(4)-2(b)(4) of the Advisers Act.

[92] Similarly, if the proposed Safeguarding Rule is adopted, the Custody Rule would then require non-securities funds advised by RIAs—such as real estate or commodities funds, which previously escaped the purview of the Custody Rule—to conduct an annual audit and may face increased costs.

[93] The SEC estimates that more than 90% of the total number of hedge funds and private equity funds currently undergo a financial statement. Adopting Release, footnote 501, page 169.

[94] Within the context of the Adviser-Led Secondaries Rule, an “election form” is a written solicitation distributed by, or on behalf of, the adviser or any related person requesting private fund investors to make a binding election to participate in an adviser-led secondary transaction. The Rules, section 211(h)(1)-1 (definition of “election form”). See also Adopting Release, footnote 601, page 200.

[95] Such summary of material business relationships must also be provided to fund investors prior to the due date of the election form of the transaction. Adopting Release, page 200.

[96] See Adopting Release, page 199.

[97] See Adopting Release, page 190.

[98] Adopting Release, footnote 600, page 200. See footnote 435 of the Adopting Release for the SEC’s outlined sources of guidance regarding electronic delivery, page 149.

[99] See endnote 59, above, for a brief description of the general recordkeeping requirements of the Books and Records Rule.

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